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BANKING DEREGULATION IN INDONESIA: AN UPDATED PERSPECTIVE IN LIGHT OF THE ASIAN FINANCIAL CRISIS

MICHAEL S. BENNETT*

1. INTRODUCTION

In 1995, I published an article in the University of Pennsylvania Journal of International Business Law entitled "Banking Deregulation in Indonesia."¹ In that article, I argued that the reforms made to the regulatory framework of the Indonesian banking system since 1988² had left the banking sector in a pre-

* Vice President, Chase Securities Japan Ltd. This Article does not represent the views or opinions of Chase Securities. This Article contains statements which are based on author's personal experience and knowledge gained from dealings with Indonesian attorneys, bankers, and entities.

¹ Michael S. Bennett, *Banking Deregulation in Indonesia*, 16 U. PA. J. INT'L BUS. L. 443 (1995).

² In October 1988, Bank Indonesia enacted a package of banking reforms known as PAKTO '88. Among other things, PAKTO '88 relaxed the restrictions on the establishment of private and foreign-owned banks, as well as those restrictions on existing banks opening new branches. For a general description

carious situation. In the interests of liberalizing the banking system, the regulatory reforms had led to a proliferation of dangerously undercapitalized and poorly supervised banks. Although the reform process had succeeded in transforming a static banking sector, dominated by a small number of state owned banks, into a more competitive system with over 230 banks by 1997, I argued that the lack of effective prudential regulation and controls had made the country susceptible to a significant and system-wide banking crisis.

The concerns I expressed about the Indonesian banking system in that article were neither uniquely my own, nor based on pure speculation. By 1995, several Indonesian banks had experienced scandals that constituted the first clear, empirical evidence of the dangers faced by the Indonesian banking sector as a whole.³ One such scandal that attracted wide scale attention was the collapse of Bank Summa in 1992. At the time of Bank Summa's liquidation, it was estimated that more than seventy percent of its loan portfolio was non-performing and that a high percentage of those loans had been made to affiliated companies.⁴ In total, the bank had amassed more than US\$700 million in nonperforming loans.⁵

Bank Summa was not a marginal participant in the banking sector, and therefore its insolvency could not be dismissed as simply an aberration. This bank was one of the first wave of private banks established after the enactment by Bank Indonesia⁶ of the

of PAKTO '88, see *Deregulating Indonesia: It's the Banks' Turn*, E. ASIAN EXECUTIVE REP., Nov. 1988, at 9; see also *Paving the Way for Growth*, INSTITUTIONAL INVESTOR, Nov. 29, 1992, at 2 (discussing the private sector's strong response to sweeping deregulation).

³ See Peter Halesworth, *Indonesia: Trade & Investment— Banking: Eliminating a Scourge*, FAR E. ECON. REV. 62, May 18, 1995.

⁴ On the collapse of Bank Summa, see Tony Shale, *Top-Level Shakeout Needed to Mend the Financial System*, EUROMONEY, June 1993, at 55 [hereinafter *Top-Level Shakeout*]; see also Richard Borsuk, *Indonesia Bolsters Its Commitment to Tight Rein on Credit*, ASIAN WALL ST. J. WKLY., Jan. 24, 1994, at 17.

⁵ See *Top-Level Shakeout*, *supra* note 4, at 55.

⁶ Bank Indonesia is Indonesia's central bank and is responsible for the implementation of the government's monetary policies and the general supervision of the country's banks. For a general overview of the functions and organization of Bank Indonesia, see *About BI* (visited Jan. 20, 1999) <<http://www.bi.go.id/intl/about/index.html>> [hereinafter *Bank Indonesia Homepage*].

1988 banking reforms.⁷ Prior to its collapse, Bank Summa was one of the ten largest banks in Indonesia and was owned by the Soeryadjaya family, who also maintained a controlling interest in Astra International, one of Indonesia's largest conglomerates.⁸

Moreover, the scandals in the Indonesian banking sector were not limited to the private banks. Another case, which cast doubt on the effectiveness of both Indonesia's banking regulators and its prison officials, was an incident involving the government-owned development bank, Bank Bapindo.⁹ In 1994, Bapindo lent approximately US\$430 million to the Golden Key group, a then little known Indonesian conglomerate owned by a businessman named Eddy Tansil.¹⁰ The loan was never repaid and a later government investigation alleged that the loan had been extended based on fraudulent documentation and with the complicity of certain Bapindo executives and government officials.¹¹

Ultimately, Tansil and several Bapindo executives were convicted of fraud by an Indonesian court and sentenced to prison in 1995.¹² Within a year of these convictions, however, the incident returned to the headlines when Tansil escaped from prison, apparently with the assistance of certain of his jailers.¹³ Bapindo was

⁷ See Jack Lowenstein, *Reaping the Rewards of Reform*, EUROMONEY SPECIAL SUPP., Dec. 1, 1989, at 2.

⁸ At the time, Astra International was Indonesia's second largest company by stock market capitalization. On the Soeryadjaya family's control of Bank Summa and Astra International, see Suhaini Aznam, *Father Knows Best*, FAR E. ECON. REV., June 25, 1992, at 62. The collapse of Bank Summa ultimately caused the Soeryadjaya family to sell its controlling interest in Astra International. See Suhaini Aznam, *Sold, at Last*, FAR E. ECON. REV., Jan. 28, 1993, at 54.

⁹ "Bapindo" is an acronym for the bank's name in Bahasa Indonesia, Bank Pembangunan Indonesia.

¹⁰ See, e.g., *Golden Key Hole*, ECONOMIST, Apr. 30, 1994, at 84; Victor Mallet, *Top Bankers Held in \$430M Scandal*, FIN. TIMES, Mar. 19-20, 1994, at 4.

¹¹ Several high-ranking officials were implicated in the Golden Key scandal, including former minister of finance Johannes Sumarlin, who at the time was also a member of Bapindo's board of commissioners. Although Sumarlin was never charged in connection with the incident, it was alleged that the letter of credit was approved by Sumarlin based on the informal reference of several other senior government officials. See Economy: Bapindo Scandal Highlights Crisis in Banking Industry, *Economist Intelligence Unit - Country Report*, Aug. 5, 1994.

¹² See *Businessman Jailed for 17 Years over Indonesia's Biggest Fraud Case*, AGENCE FR.-PRESSE, Aug. 15, 1994, available in 1994 WL 9621345.

¹³ See Maggie Ford, *Smoothing the Bumpy Road*, EUROMONEY, Apr. 1997, at 175 [hereinafter *Smoothing the Bumpy Road*]; see also Eddy Tansil, *Figure at*

never fully recapitalized after the losses incurred in the Golden Key scandal, which left it as one of the financially weakest of the state-owned banks.¹⁴

Bank Summa's collapse and the Golden Key scandal were just two of the more visible incidents involving Indonesian banks that called attention to the lack of effective banking regulation in the country.¹⁵ These incidents showed that even banks owned, in one case, by the government and, in another case, by one of the country's most powerful industrialist families, were capable of significant mismanagement and were operating without effective internal or external controls.

The cracks that were already showing in Indonesia's banking framework by 1995 became wide fissures under the stress of the financial crisis that occurred throughout much of Asia beginning in the Spring of 1997.¹⁶ Undercapitalized and, in large part, burdened with poorly diversified and badly performing loan portfolios, the vast majority of Indonesian banks were not in a position to weather any kind of serious shock to the financial system. And, the shocks that occurred in connection with the Asian fi-

Center of Bapindo Collapse, Escapes Jail, JAKARTA POST, May 8, 1996, at 1, available in LEXIS, News Library, Allbnn File.

¹⁴ See *Smoothering the Bumpy Road*, *supra* note 13, at 176.

¹⁵ See *Indonesia Closes Troubled Banks as Part of Economic Bailout*, N.Y. TIMES ABSTRACTS, Nov. 2, 1997, at § 1, 1, available in 1997 WL 8010755.

¹⁶ The term "Asian financial crisis" will be used in this article to refer generally to the currency devaluations and negative capital flows that occurred throughout Southeast Asia and South Korea beginning in the Summer of 1997. Although a number of events that occurred in early 1997, including the bankruptcy of the Hanbo Group in South Korea in January, could be considered to be part of the crisis, the Asian financial crisis is frequently dated from mid-May, 1997, when the Thai baht first was put under pressure from speculators who sold the baht aggressively. Speculative attacks quickly followed on other Asian currencies, including the Philippine peso, the Malaysian ringgit, the Korean won, the Singapore dollar, the Hong Kong dollar and the Indonesian rupiah. On the Asian financial crisis generally, see Giancarlo Corsetti et al., *What Caused the Asian Currency and Financial Crisis?*, in Nouriel Roubini's *Asia's Economic and Currency Crisis* (last visited Feb. 16, 1999) <<http://www.stern.nyu.edu/~nroubini/asia/asiahomepage.html>> [hereinafter *Asia Crisis Homepage*]; Paul Krugman, *What Happened to Asia?* (last visited Feb. 16, 1999) <<http://web.mit.edu/krugman/www/disinter.html>>; Rudi Dornbusch, *Asia Crisis Themes*, available in *Asia Crisis Homepage*, *supra*; Javad K. Shirazi, *The East Asian Crisis: Origins, Policy Challenges and Prospects* (last visited Feb. 16, 1999) <<http://www.worldbank.org/html/extdr/offrep/eap/jkssp061098.htm>>; Morris Goldstein, *The Asian Financial Crisis* (last modified Mar. 1998) <<http://www.iie.com/news98-1.htm>>; see also Martin Wolf, *Ins and Outs of Capital Flows*, FIN. TIMES, June 16, 1998, at 25.

nancial crisis, which included a rapid devaluation of the Indonesian rupiah against the U.S. dollar and most other major currencies¹⁷ and a large scale withdrawal of foreign private capital,¹⁸ certainly constituted serious shocks to the system. The weaknesses of the Indonesian banking sector made it very vulnerable to such shocks.

The Asian financial crisis left the vast majority of Indonesian banks insolvent and necessitated large scale intervention by the Indonesian government to prevent a general collapse of the country's banking system.¹⁹ The scale of the government's interven-

¹⁷ The Indonesian rupiah ("rupiah" or "IDR") first came under severe pressure on August 13, 1997, when the IDR fell to its then historic low of 2,682 against the U.S. dollar ("U.S. dollar" or "USD") before Bank Indonesia intervention briefly halted the currency's decline. See *Bank Indonesia Steps in to Stop Rupiah Plunge*, ABIX (Australasian News Abstracts), Aug. 14, 1997, available in 1997 WL 18227634. The next day, the rupiah fell to 2,755 against the U.S. dollar when the Indonesian government abolished the exchange rate intervention band system and let the currency freely float against the U.S. dollar. See Susan Sim, *Indonesian Central Bank Ups Some Short-Term Interest Rates: Rupiah and Baht Hit New Lows as Speculators Pile on Pressure*, SINGAPORE STRAITS TIMES, Aug. 20, 1997, available in 1997 WL 12143282. Since then, the IDR-USD exchange rate has been very volatile. To illustrate the rupiah's volatility against the U.S. dollar, the following are the closing spot rates on certain random dates over the one year period following August 13, 1997: October 6, 1997: USD 1 = IDR 3,705; December 9, 1997: USD 1 = IDR 4,550; January 1, 1998: USD 1 = IDR 5,450; January 28, 1998: USD 1 = IDR 12,500; February 16, 1998: USD 1 = IDR 9,950; June 17, 1998: USD 1 = IDR 16,150; July 31, 1998: USD 1 = IDR 13,300; and August 13, 1998: USD 1 = IDR 13,200. Bloomberg News Service, *Historical Price Traded Currency* (search for Indonesian Rupiah spot rate). See also *Chronology of the Asian Currency Crisis and its Global Contagion*, available in *Asia Crisis Homepage*, *supra* note 16.

¹⁸ Private capital flows to Indonesia from abroad, which (expressed as a percentage of gross domestic product) had increased by 2.6% from 1995 to 1996, decreased by 6.1% from 1996 to 1997. See Shirazi, *supra* note 16. The reverse of capital flows to Indonesia from a net positive to a net negative was part of a general trend that occurred throughout Southeast Asia and South Korea during the Asian financial crisis. See Burton Malkiel & J.P. Mei, *Containing Chernobyl*, FIN. TIMES, Oct. 7, 1998. In the aggregate, private capital flows to South Korea, Thailand, Indonesia, Malaysia and The Philippines changed from a US\$93 billion inflow in 1996 to a US\$12 billion outflow in 1997. See *id.*

¹⁹ See, e.g., Dan Murphy, *Bank Indonesia Figures Shows Banks on Life Support*, BLOOMBERG NEWS, Mar. 3, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Banks on Life Support*]. It is estimated that the Indonesian government injected approximately 141.6 trillion rupiah (roughly US\$12 billion) into the country's banking system during the Asian financial crisis, including approximately 50 trillion rupiah in January 1998 alone. See Dan Murphy et al., *Indonesia Detains 2 Bankers; Tries to Recoup \$12 Bln*, BLOOMBERG NEWS, Sept. 11, 1998, available in LEXIS, News Library, Allbnn File [hereinaf-

tion was unprecedented in Indonesia's financial history.²⁰ Several banks, for example, including the state-owned Bank Ekspor-Import, are reported to have received liquidity support from Bank Indonesia in an aggregate amount equal to more than 500% of their stated capital.²¹ The government's provision of liquidity support to the banks contributed significantly to the rapid decline in the level of the country's foreign exchange reserves.²² This decline in foreign reserves, combined with the country's high level of external debt,²³ resulted in Indonesia needing substantial financial assistance from the International Monetary Fund, the Asian Development Bank, and other sovereign and multi-national organization lenders.²⁴

ter *Indonesia Detains Two Bankers*]; Maggie Ford, *Waking Up to Reality*, EUROMONEY, May 1998, at 46 [hereinafter *Waking Up*]; Dan Murphy, *Indonesian Broad Money Supply Surged 27 Percent in January*, BLOOMBERG NEWS, Mar. 4, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Money Supply Surged*]; *Indonesian Banks: Tough Choices*, ECONOMIST, July 18, 1998, at 64.

²⁰ For example, Bank Indonesia injected 39 trillion rupiah into the banking system during one period in early January 1998, as compared with 429 billion rupiah during a period of similar length in July 1997 before the Asian financial crisis. See *Banks on Life Support*, *supra* note 19.

²¹ See *Govt's Bank Loan Converted into Equity*, JAKARTA POST, Sept. 9, 1998, available in LEXIS, News Library, Jkpost File.

²² Bank Indonesia figures showed that by March 1998 Indonesia's foreign exchange reserves had fallen 43% after reaching their historical high of US\$28.85 billion in June 1997, immediately before the Asian financial crisis. See *Banks on Life Support*, *supra* note 19.

²³ According to Bank Indonesia figures released on May 13, 1998, the Indonesian public sector's total external debt as of February 28, 1998 was more than US\$65 billion. See *RI Foreign Debt Drops to US\$ 131.7 Billion* BI, JAKARTA POST, May 14, 1998, available in LEXIS, News Library, Jkpost File. This foreign debt burden ultimately required the Indonesian government to undertake debt rescheduling negotiations with its international creditors. See *Debt Rescheduling Likely to Strengthen Indonesian Rupiah*, ASIA PULSE, Sept. 28, 1998, available in LEXIS, News Library, Apulse File. In September 1998, Indonesia reached an agreement with its major international lenders to reschedule US\$4.2 billion of its sovereign debt. See *id.* This agreement, which was reached under the auspices of the so-called "Paris Club" of creditor nations, involved rescheduling all sovereign debt due between August 6, 1998 and March 31, 2000 for a period of between 11 and 20 years. See I. Made Sentana & Alan R. Katz, *Indonesia Wins Rollover for \$4.2 Billion of Debt*, ASIAN WALL ST. J., Sept. 24, 1998, at 3; Sander Thoenes, *Jakarta \$4.2Bn Debt Deals*, FIN. TIMES, Sept. 24, 1998, at 6; Bank Indonesia, *Rescheduling/Refinancing of Principal Installments of Government Debt Under Paris Club*, Oct. 7, 1998, in *Bank Indonesia Homepage*, *supra* note 6.

²⁴ In total, sovereign and multi-national organization lenders pledged approximately US\$43 billion in aid to Indonesia in a program coordinated by the

Despite the size of the intervention, the government's injection of funds into the country's banks in the wake of the Asian financial crisis did not amount to a much needed recapitalization of the banking system. Rather, the intervention was simply a stop-gap measure to maintain minimum levels of banking sector liquidity. The funds were used by the banks to meet their immediate liquidity needs and therefore the intervention, although successful to the extent of preventing a total system-wide collapse, did not leave the banking system in a materially stronger position that would enable it to move forward. The government's actions were, in other words, simply a band-aid rather than a cure.

Even the band-aid of massive government intervention was not sufficient, however, to alleviate the bleeding in much of the banking sector. When the provision of liquidity support alone proved to be insufficient to maintain overall bank solvency, the Indonesian government began taking more direct and severe action. In November 1997, the Ministry of Finance ordered the liquidation of sixteen private banks.²⁵ At the same time, the government began assuming control over banks which had run up extremely large negative balances with Bank Indonesia. By Octo-

International Monetary Fund, with the distribution of such aid conditioned on Indonesia undertaking a variety of reforms. For the text of the Memorandum of Economic and Financial Policies between the International Monetary Fund and the Government of Indonesia see *Indonesia—Memorandum of Economic and Financial Policies* (last visited Feb. 17, 1999) <<http://www.imf.org/external/np/LOI/011598.htm>> [hereinafter *IMF Homepage*]. See, e.g., David E. Sanger, *After Compromises, Indonesians Reach 3d Pact With I.M.F.*, N.Y. TIMES, Apr. 8, 1998, at A1; see also Dan Murphy, *Asian Development Bank to Lend Indonesia \$3.5 Billion*, BLOOMBERG NEWS, Oct. 31, 1997, available in LEXIS, News Library, Allbnn File [hereinafter *Asian Development Bank*]. On the changing attitudes of Indonesian officials with respect to international financial aid, see Jay Solomon, *Wavering Hopes: Jakarta Questions Reliance on IMF and World Bank*, ASIAN WALL ST. J., Oct. 7, 1998, at 1. Separate from the International Monetary Fund led program, the Islamic Development Bank pledged US\$600 million of assistance to Indonesia in September 1998. See Sabine Hassen, *Islamic Development Bank to Allocate \$600 Million to Indonesia*, Sept. 13, 1998, BLOOMBERG NEWS, available in LEXIS, News Library, Allbnn File.

²⁵ The liquidated banks were: Bank Harapan Sentosa, Sejahtera Bank Umum, Bank Andromeda, Bank Pacific, Bank Astria Raya, Bank Guna Internasional, Bank Dwipa Semesta, Bank Kosagraha Semesta, Bank Industri, Bank Jakarta, Bank Citrahasta Dhanamanunggal, South East Asia Bank, Bank Mataran Dhanarta, Bank Pinaesaan, Bank Anrico, and Bank Umum Majapahit Jaya. See *List of 16 Indonesian Banks Closed, Liquidated from Nov. 1*, BLOOMBERG NEWS, Nov. 1, 1997, available in LEXIS, News Library, Allbnn File [hereinafter *List of 16 Banks*].

ber 1998, the government ordered the liquidation of another ten banks²⁶ and controlled approximately seventy percent of the total assets in the Indonesian banking system.²⁷ As these figures suggest, the Asian financial crisis left most of Indonesia's more than 200 banks as virtual wards of the state, with their solvency dependent entirely on government support.²⁸

In my 1995 article, I summarized the regulatory framework of the Indonesian banking industry, focusing on the principal laws and regulators.²⁹ I then traced the history of the government's deregulation efforts and questioned the wisdom of those efforts based on the weak financial condition of the majority of the country's banks.³⁰ Finally, I attempted to place Indonesia's banking reforms in the context of similar banking deregulation programs implemented in Southeast Asia and argued that Indonesia's reforms were materially different from the efforts of its neighbors both because of the accelerated pace of the reforms and the weakened position in which the reforms had left the country's banks.³¹

The purpose of this article is to re-examine Indonesia's deregulation of its banking system in light of the Asian financial crisis. Although I will discuss capital flows, interest rate changes, and other economic issues, this article is not intended to be an in-depth economic analysis of the financial crisis itself. Rather, it is primarily a legal analysis of a regulatory system and the relationship of that system to certain economic events. First, I will look at the impact of the Asian financial crisis on the Indonesian banking sector. Next, I will examine how the banking deregulation

²⁶ See, e.g., *Uncertainty Looms Over Indonesian Banks*, INT'L FINANCING REV., Aug. 29, 1998, at 42; Oxford Analytica Ltd., *Indonesia: Bank Repayments* (last modified Sept. 28, 1998) <<http://www.oxan.com/asia07.html>> [hereinafter *Indonesia: Bank Repayments*]; Sri Mulyani Indrawati & Ali Wardono, *Indonesian Economic Reconstruction: Where Do We Start?*, Speech at the Overcoming the Current Economic Downturn Conference (Aug. 23, 1998) in <<http://www.indoexchange.com>> [hereinafter *Indonesia Exchange Homepage*].

²⁷ See *Indonesia Weighs Pumping More Money into Banks, Sabirin Says*, BLOOMBERG NEWS, Aug. 19, 1998, available in LEXIS, News Library, Allbnn File (indicating that "[r]oughly 70 percent of the assets in the banking system" were under government control).

²⁸ See *Uncertainty Looms Over Indonesian Banks*, *supra* note 26 (discussing the degree of governmental control over its banks).

²⁹ See Bennett, *supra* note 1, at 449-53.

³⁰ See *id.* at 454-70.

³¹ See *id.* at 470-81.

program pursued by the Indonesian government since 1983, and in particular since the reforms enacted in 1988, left the banking sector vulnerable to a system-wide collapse. Finally, I will review the efforts made by the government to control the banking collapse and to begin to rebuild the banking sector in the wake of the Asian financial crisis.

2. THE IMPACT OF THE ASIAN FINANCIAL CRISIS ON INDONESIAN BANKS

A properly functioning banking system is an essential part of a nation's economic well-being. Because banks serve as allocators of capital as well as protectors of the national payment system, their importance to a country's economic infrastructure goes far beyond their contribution to the gross national product. The presence of financially secure banks is also important for maintaining public confidence in the economy. Bank failures undermine that confidence and thus have negative consequences for a country's economy that often are disproportionately large compared to the actual harm done to the failed bank's depositors, borrowers and other constituents.³² Such negative consequences can include reduced consumption and investment, as both individuals and companies curtail their spending out of concerns about the country's economic future.

One measure of the health of a country's banking system is the ability of the system to withstand periods of unusually high levels of economic distress. By this standard, as well as several others, the Indonesian banking system receives very poor marks. The Asian financial crisis substantially decimated Indonesia's overbanked³³ and undercapitalized banking sector, exposing the core weaknesses of the system that were less evident in earlier

³² For a brief, but informative, description of the dangers posed by bank failures, see *Please, Governor, Can You Spare a Billion?*, *ECONOMIST*, Mar. 25, 1995, at 79.

³³ Although no accurate formula exists for determining the optimal number of banks in any country, a comparison of the number of banks in Indonesia with the aggregate amount of assets in the banking system suggests that, by international standards, Indonesia had an unusually large number of banks for the total asset size of its bank market. See Standard & Poor's, *Indonesian Banks Survive Ongoing Stress*, *BLOOMBERG NEWS*, Nov. 8, 1995, available in Bloomberg News Service [hereinafter Standard & Poor's Creditwire Report on Indonesia].

years when general growth throughout the Indonesian economy buoyed bank profits.³⁴

One reason for the Indonesian banking system's vulnerability to the effects of the Asian financial crisis was that the loan portfolios of most of its banks concentrated in loans made to the real estate sector. Bank Indonesia's own figures show that bank lending to the property sector increased by nearly forty percent from 1995 to 1996.³⁵ By late 1997, analysts estimated that the property sector received twenty-five percent of all bank loans.³⁶ Even these figures most likely understate the degree of exposure that Indonesian banks had to the real estate market. Private banks lent much property to affiliated property companies and may have underreported to avoid sanctions for violating the affiliated lending limits imposed by the Banking Law.³⁷

Large-scale exposure to property companies became a serious problem for Indonesian banks by the time of the Asian financial crisis because highly speculative overbuilding, particularly in the Jakarta area, occurred in the Indonesian property sector throughout the 1990's.³⁸ The easy availability of bank credit in part fu-

³⁴ Gross domestic product ("GDP") growth in Indonesia averaged roughly seven percent per year from 1967, when Suharto took over the presidency, until 1997. See *Indonesia: The Long March*, ECONOMIST, Apr. 17, 1993, at 3, 3. GDP growth slowed to 5.7% in 1997, reflecting the onset of the Asian financial crisis, and as of late 1998, many analysts forecasted GDP growth to be a negative 15 to 20% in 1998. See Grainne McCarthy, *Indonesia's GDP Shrank by 17.4% in Third Quarter*, ASIAN WALL ST. J., Oct. 6, 1998, at 3.

³⁵ See J. Soedradjad Djiwandono, *The Banking Industry Facing the 21st Century* (visited Jan. 20, 1999) <<http://www.bi.go.id/intl/speeches/century.htm>> [hereinafter *Banking Industry*].

³⁶ See Maggie Ford, *Now Comes the Real Crisis*, EUROMONEY, Dec. 1997, at 44, 45 [hereinafter *Real Crisis*].

³⁷ See Banking Law, Law No. 7 of 1992; *Real Crisis*, *supra* note 36, at 45 (estimating that as much as US\$15 billion of Indonesian bank lending may have gone unrecorded). The affiliate lending restrictions limited the aggregate amount that could be lent to affiliated companies to 20% of a bank's capital. Many of the private banks are believed to have substantially violated those restrictions. See *Indonesia: Bank Repayments*, *supra* note 26 (stating that 16 of the 24 liquidated banks allegedly violated the legally defined limits on lending activities). Bank Modern, for example, admitted after the government shut it down in August 1998 that it lent 65% of its capital to affiliates in the Modern Group. See Alistair Hammond, *Indonesia's Modern Group to Repay 2.1 Tln Rupiah in Govt Debt*, BLOOMBERG NEWS, Sept. 11, 1998, available in LEXIS, News Library, Allbnn File.

³⁸ See, e.g., *Asian Property: Situations Vacant*, ECONOMIST, Apr. 12, 1997, at 72, 72 (stating that Jakarta had vacancy rates of 13.7% and climbing); Richard Borsuk, *Indonesia's State Banks Are in Precarious Shape*, ASIAN WALL ST. J.,

eled this overbuilding. By one estimate, bank loans accounted for 95% of the financing for property development in Indonesia.³⁹

Even as the glut in the property market became apparent and real estate prices began to decline, Indonesian banks continued to lend aggressively to property companies. In 1997, for example, despite large-scale losses being reported by the property industry,⁴⁰ Indonesian bank lending to the property sector totaled approximately 19.4 trillion rupiah, a 21% increase from 1996.⁴¹ As interest rates rose and property prices and occupancy rates declined in the wake of the Asian financial crisis, new construction activity ceased almost entirely, and the income from existing properties contracted as increasing numbers of retail and other commercial tenants either went out of business or moved to less expensive space.⁴²

The deteriorating property market caused large numbers of property companies to default on their loans.⁴³ In some cases, banks had taken a pledge over property as collateral for such loans.⁴⁴ However, the insolvency laws and regulations and other

Oct. 20, 1994, at 4 (forecasting bad debts due to a glut in property projects); Henny Sender, *Space Race: Jakarta's Real-Estate Market Headed for Trouble?*, FAR E. ECON. REV., Aug. 4, 1994, at 56, 56 (questioning aggressive practices in an oversupplied market).

³⁹ Because of the high level of exposure that Indonesian banks had to the property sector, the government attempted to curb bank funding for property projects immediately prior to the Asian financial crisis. In July 1997, Bank Indonesia issued a decree that was intended to severely restrict bank credit to real estate developers. See *Decree of the Board of Directors of Bank Indonesia on the Limitation for Credits Provided by Public Banks for the Financing of Provisioning and or Processing of Land* (visited Jan. 20, 1999) <<http://www.bi.go.id/intl/circulars/sk973046.htm>>.

⁴⁰ See *Indonesian Companies' 1997 Results Reflect Pain; Worse to Come*, BLOOMBERG NEWS, Apr. 30, 1998, available in LEXIS, News Library, Allbnn File.

⁴¹ See Alistair Hammond, *Million Indonesian Construction Workers to Lose Jobs in '98*, BLOOMBERG NEWS, Dec. 19, 1997, available in LEXIS, News Library, Allbnn File.

⁴² See, e.g., *Jakarta Office Demand Likely to Fall Up to 40% in 1998-1999*, BLOOMBERG NEWS, Oct. 15, 1997, available in LEXIS, News Library, Allbnn File (noting that potential renters and buyers are likely to ask for better terms).

⁴³ The impact of the Asian financial crisis caused roughly 75% of Indonesia's registered construction companies to cease operations. See *About 75% of Indonesia's Construction Firms Out of Business*, BLOOMBERG NEWS, Apr. 19, 1998, available in LEXIS, News Library, Allbnn File.

⁴⁴ See *Indonesia's Trakindo Reaps Reward of Hedging Debt*, BLOOMBERG NEWS, Oct. 14, 1998, available in LEXIS, News Library, Allbnn File.

collateral enforcement procedures in Indonesia were so underdeveloped that banks could not realistically choose to foreclose on pledged property.⁴⁵ Moreover, even had foreclosure been possible, the steep fall in real estate prices meant that by the time of the default the property used to secure a loan often was worth only a fraction of the outstanding loan principal amount.

In addition to defaults by property companies, high concentrations of loans to the property sector left Indonesian banks vulnerable to the Asian financial crisis for another reason: the dependence of many banks on short term funding from overseas.⁴⁶ By their nature, loans to the property sector tend to have relatively long terms and be serviced by local currency cashflows.⁴⁷ Indonesian banks funded many of these loans, however, with relatively short-term funding from foreign sources denominated in U.S. dollars, Japanese yen and other foreign currencies.⁴⁸

Short-term borrowing from abroad was a relatively inexpensive source of funds,⁴⁹ provided that the banks did not incur additional costs purchasing hedging instruments to protect themselves from any depreciation of the rupiah against the currency they had borrowed. Unhedged foreign currency borrowing posed an obvious risk to a bank; any depreciation of the rupiah during the term of the loan would mean that the amount of rupiah needed to repay the loan on maturity would be greater than the amount re-

⁴⁵ This conclusion is based on discussions I have had with various Indonesian lawyers. Interview and discussion with Indonesian lawyers and bankers, in Jakarta, Indonesia (1996 & 1997) [hereinafter Interview]. In general, foreclosure on pledged property under Indonesian law requires use of a cumbersome court-administered auction procedure.

⁴⁶ See Shirazi, *supra* note 16; *Asia Crisis Homepage*, *supra* note 16.

⁴⁷ Although loans to the real estate sector in Indonesia are, for the most part, serviced by rupiah cashflows, certain retail and commercial developments in Jakarta and other large cities generate U.S. dollar payments. Certain first class malls, for example, charge tenants rent in U.S. dollars. See, e.g., *Indonesian Malls Owners Urged to Stop Charging Rents in Dollars*, BLOOMBERG NEWS, Dec. 28, 1997, available in LEXIS, News Library, Allbnn File ("The Indonesian Franchise Association (AFI) is urging mall operators to charge rents in rupiah, not dollars . . .").

⁴⁸ The total outstanding external short term debt in Indonesia increased from US\$19.5 billion in 1994 to US\$32.3 billion in 1996. See Shirazi, *supra* note 16.

⁴⁹ See Shirazi, *supra* note 16 (discussing the flow of investment capital to the so-called "emerging market economies," such as Indonesia, in the years immediately prior to the Asian financial crisis and the historically tight credit spreads accepted during such period by investors for emerging market credits).

ceived by the borrower upon drawing the loan. Nevertheless, the Indonesian government's foreign exchange rate policy unintentionally provided an economic rationale for leaving foreign currency exposure unhedged prior to the Asian financial crisis.⁵⁰

Until August 14, 1997, the Indonesian government maintained an intervention band system under which the government pledged to intervene in the markets, through such means as foreign exchange purchases and interest rate adjustments, if the rupiah depreciated or appreciated against the U.S. dollar beyond a set percentage.⁵¹ Assuming that the government would maintain the intervention band, an Indonesian bank borrowing in U.S. dollars simply could compare the cost of purchasing a hedging instrument with the maximum depreciation of the rupiah against the U.S. dollar permitted under the intervention band during the term of the loan. Hedging the currency exposure only would be economically justified, therefore, when the cost of the hedging instrument was less than the maximum potential depreciation of the rupiah under the intervention band system.

Because short-term funding on an unhedged basis is so attractive, much of the Indonesian banking sector's foreign borrowing has remained unhedged.⁵² Indonesian banks, therefore, were faced with an unhedged funding mismatch between borrowing short-term from abroad in foreign currency and lending long-term in rupiah.⁵³ This funding mismatch, combined with the general refusal of foreign banks to extend new loans after the Asian financial crisis began, put the Indonesian banking sector in a very precarious position.

When the Indonesian government abolished the intervention band system on August 14, 1997 in the face of large-scale selling of

⁵⁰ See Ali Wardhana, *Overcoming the Current Economic Downturn* (last modified Aug. 25, 1998) <<http://www.indoexchange.com>>; see also Shirazi, *supra* note 16.

⁵¹ See *Monetary Policy* (visited Jan. 20, 1999) <<http://www.bi.go.id/intl/policies/index.html>> [hereinafter *Indonesia Monetary Policy*]; see also Claire Leow et al., *Indonesia Floats the Rupiah; Currency Sinks 5%*, BLOOMBERG NEWS, Aug. 14, 1997, available in LEXIS, News Library, Allbnn File. For a discussion of the abandonment of the intervention band system, see also *Termination of the Rupiah Intervention Band* (visited Jan. 20, 1999) <<http://www.bi.go.id/intl/press/304pr1997.htm>>.

⁵² See Shirazi, *supra* note 16.

⁵³ See generally Jeffrey D. Sachs, *The Wrong Medicine for Asia*, N.Y. TIMES, Nov. 3, 1997, at A23 (describing the IMF Asian bailout proposal); Corsetti et al., *supra* note 16.

rupiah in the foreign currency markets, the rupiah depreciated sharply against the U.S. dollar and other currencies in which the Indonesian banks had borrowed.⁵⁴ Because of the depreciation of the rupiah, the amount of rupiah that Indonesian banks earned on their long-term loans to the property sector and other industries, even assuming those loans were all fully performing, was no longer sufficient to service their short-term foreign borrowings.⁵⁵ Moreover, the banks could no longer attract new funds from abroad that could be used to repay the short-term borrowings that were maturing.⁵⁶

At the same time that banks were losing their foreign funding sources, it was becoming increasingly difficult for them to source funds in the domestic market. In response to the devaluation of the rupiah, the Indonesian government raised short-term rupiah interest rates in order to try to stabilize the fall of the currency, thereby increasing the cost of funds for the banking sector.⁵⁷ During one week in mid-August 1997, for example, the overnight interbank lending rate was increased by over 36%.⁵⁸

In the interest of protecting the rupiah, Bank Indonesia also temporarily suspended several of the means which Indonesian banks use to obtain short-term liquidity, including its purchase of SBPU and its repurchase facility for SBIs.⁵⁹ Bank Indonesia uses

⁵⁴ See *supra* text accompanying note 17.

⁵⁵ See *id.*

⁵⁶ See, e.g., Shirazi, *supra* note 16; Goldstein, *supra* note 16.

⁵⁷ See *Indonesia Monetary Policy*, *supra* note 51; see also Andi Asrun, *Soedradjad Says Rates Protect Rupiah, Ensure Smart Borrowing*, BLOOMBERG NEWS, Aug. 19, 1997, available in LEXIS, News Library, Allbnn File; *Bank Indonesia Appeals Strict Monetary Policy* (visited Jan 20, 1999) <<http://www.bi.go.id/intl/press/50Spr1997.htm>> (Bank Indonesia press release dated August 20, 1997).

⁵⁸ On Monday, August 11, 1997, the overnight interbank rupiah rate ("JIBOR") was 15.875%. By Monday of the following week (August 18, 1997) the overnight JIBOR was 51.429%, and by Friday of that week (August 22, 1997) the overnight JIBOR was 87.778%. See, e.g., Dan Murphy, *Indonesian Overnight Interbank Lending Rate Surges to 51.42%*, BLOOMBERG NEWS, Aug. 18, 1997, available in LEXIS, News Library, Allbnn File [hereinafter *Lending Rate Surges*].

⁵⁹ See *Indonesia Monetary Policy*, *supra* note 51. SBPU is an acronym for "Surat Berharga Pasar Uang" and SBI is an acronym for "Sertifikat Bank Indonesia." SBPU are generally issued with one or two week durations. SBIs generally are issued every Wednesday with a one month duration, but beginning in October 1998, Bank Indonesia also began issuing three month SBIs once each month. See, e.g., Bank Indonesia, *Auction Result: Certificate of Bank Indonesia (SBI)* (visited Jan. 21, 1999) <<http://www.bi.go.id/intl/press/lelan>>

SBPUs and SBIs, money market instruments, to control liquidity in the domestic banking system. In general, Bank Indonesia purchases SBPUs on a discount basis⁶⁰ from banks to inject liquidity into the system and sells SBIs to banks to absorb liquidity from the system. SBIs, however, also can be a source of liquidity for banks, because Bank Indonesia ordinarily maintains an SBI repurchase facility under which banks can sell SBIs to the central bank with an obligation to repurchase them at a later date.⁶¹ By suspending both the purchase of SBPUs and the repurchase facility for SBIs, Bank Indonesia severely tightened domestic liquidity.

A sharp public loss of confidence in most of the country's banks further aggravated the liquidity crisis faced by the Indonesian banks by leading to large-scale depositor withdrawals.⁶² Fearing bank failures in the wake of the Asian financial crisis, depositors withdrew their funds from those banks that were perceived to be weak and moved them either to stronger domestic banks or

gsbi141098.html> (Bank Indonesia press release dated October 14, 1998). See also *Indonesia to Start Selling 3-Month Treasury Bills Wednesday*, BLOOMBERG NEWS, Oct. 12, 1998, available in LEXIS, News Library, Allbnn File.

⁶⁰ Purchasing SBPUs on a "discount basis" means, in a hypothetical example, that Bank Indonesia purchases 100 rupiah principal amount of one-week SBPUs from a bank for 99 rupiah, and when those SBPUs mature one week later, the bank repays Bank Indonesia the full 100 rupiah principal amount. The difference between the principal amount and the purchase price represents the interest rate applicable to the SBPUs, which in this hypothetical example would be 52% per annum (i.e., 1% paid over one week equals 52% paid over one year).

⁶¹ Repurchase agreements (often known as "repos") are a relatively common method for obtaining funding in the capital markets. A repurchase agreement is similar to a secured loan in that the seller in a repo (like the borrower in a secured loan transaction) assigns a security to another party in exchange for cash, and, on the maturity date of the transaction, the seller repays the cash amount plus interest to the other party and receives the security in return.

⁶² See generally *Waking Up*, *supra* note 19, at 46 ("As IMF agreements were broken, locals and foreigners panicked, and investors and bankers fled in droves, demanding instant repayment of debt, cutting off letters of credit, selling down stock prices and pushing interest rates to astronomical levels."); Dr. Miranda S. Goeltom's *Virtual Interview*, (visited Jan. 21, 1999) <<http://www.bi.go.id/intl/goenom/index.html>> [hereinafter *Goeltom Interview*] (describing how operations in the banking system can go awry when the public trust deteriorates); *Indonesia Monetary Policy*, *supra* note 51 ("The situation was further aggravated by the crisis of confidence in the banking sector, which led to massive withdrawals of deposits . . .").

overseas.⁶³ This shifting of deposits primarily involved money being moved from the smaller private banks to state-owned and foreign banks, as well as to the few larger private banks that were considered to be in relatively good financial health.⁶⁴ During the period between October 1997 and January 1998, for example, Bank Indonesia figures show that, in the aggregate, approximately 24.3 trillion rupiah was withdrawn from the private banks.⁶⁵ Although much of these funds were re-deposited into state-owned and foreign banks in the country, 11.4 trillion rupiah was withdrawn from the Indonesian banking system entirely.⁶⁶

Finally, a percentage of loans that were nonperforming rapidly increased throughout the banking sector, putting further pressure on banking liquidity. The list of defaulted borrowers was not limited to the property sector. The devaluation of the rupiah, combined with the sharp increase in domestic interest rates, caused a rash of loan defaults by Indonesian manufacturers, other corporate borrowers, and property companies.⁶⁷

In the aggregate, Indonesian corporations borrowed substantially more from overseas than did the country's banks. As of the end of February 1998, for example, the total external debt incurred by Indonesian nonbank corporations stood at approximately US\$57 billion, as compared with the roughly US\$8 billion that had been borrowed from abroad by the country's banks.⁶⁸ Like banks, Indonesian companies left much of their foreign currency borrowing unhedged.⁶⁹ Thus, as the value of the rupiah plummeted against the U.S. dollar and other foreign currencies in which companies had borrowed, the total debt burden, in rupiah

⁶³ See *Waking Up*, *supra* note 19, at 47; see also Goeltom's Interview, *supra* note 62.

⁶⁴ See Alistair Hammond & Andi Asrun, *Bank Closures Trigger Concern about Other Indonesia's Banks*, Nov. 4, 1997, available in Bloomberg News Service.

⁶⁵ See Goeltom Interview, *supra* note 62.

⁶⁶ See *id.*

⁶⁷ See Hammond, *supra* note 37; see also Bambang Subianto, Speech, *Strategies for Recovery: National Financial Directives in a Regional Setting* (Aug. 25, 1998) in <<http://www.indoexchange.com/bagong/public/cms-speeches/bambong.htm>>.

⁶⁸ See *Indonesia: External Debt* (visited Jan. 21, 1999) <<http://www.bi.go.id/intl/press/bi31pr16.htm>> (Bank Indonesia press release dated May 13, 1998).

⁶⁹ See *Indonesia Monetary Policy*, *supra* note 51.

terms, of the Indonesian corporate sector increased dramatically.⁷⁰ At the same time, high interest rates were suppressing demand in the country for goods and services of all kinds, thereby depressing corporate earnings.⁷¹ Such conditions resulted in many Indonesian companies being unable to service their debts to both foreign and domestic creditors.⁷²

As a result of this combination of factors, Indonesian banks faced a severe shortage of funds that left much of the banking sector technically insolvent by September 1997.⁷³ Faced with the prospect of widespread bank failures, the Indonesian government reversed the tight monetary policies that it had been pursuing to protect the rupiah and began providing moderate liquidity support to the country's banks.⁷⁴ The government signaled its policy reversal in an economic policy package introduced by the Indonesian cabinet on September 3, 1997 that included a number of measures aimed at injecting liquidity back into the banking sector.⁷⁵

One of the measures taken by the government was to lower short-term interest rates. The one-week JIBOR rate fell, for example, from a weekly high of 72.5% during the last week of August 1997 to a weekly high of 43.8% during the first week of September 1997 when the policy package was introduced.⁷⁶ This lowering of interest rates reduced the costs incurred by banks borrowing in the interbank market. Bank Indonesia also injected funds directly into a number of banks.⁷⁷ They provided the liquidity support in the form of subordinated loans to banks as well as deposits of government funds. Bank Indonesia, for example, liquidated a large portfolio of SBIs in which it had invested state enterprise funds and deposited that money into certain government-owned banks.⁷⁸

⁷⁰ See Alistair Hammond & Andi Asrun, *supra* note 64.

⁷¹ See *id.*

⁷² See Subianto, *supra* note 67.

⁷³ See generally Goeltom Interview, *supra* note 62 (describing the effect of a rush of bank withdrawals, resulting illiquidity and insolvency).

⁷⁴ See *Indonesia Monetary Policy*, *supra* note 51.

⁷⁵ See *id.*

⁷⁶ See Bloomberg News Service, Close/Ask/Yield (search for JIBOR-RUPIAH yield).

⁷⁷ *Indonesia Monetary Policy*, *supra* note 51.

⁷⁸ See *id.*

Most importantly, however, Bank Indonesia re-opened both the SBPU facility and the SBI repurchase facility for banks that met certain criteria.⁷⁹ The primary criteria for using these discount facilities was that the banks resume lending to small scale enterprises, a sector of the economy that had been particularly devastated by the tight credit conditions following the Asian financial crisis.⁸⁰ The re-opening of the SBPU and SBI facilities provided a ready source of short-term funding for the roughly seventy banks that met Bank Indonesia's requirements.

Moreover, the interest rates that banks paid for SBPU financing were kept artificially low as an additional type of government subsidy to the banking sector.⁸¹ Bank Indonesia maintained low SBPU rates by purchasing SBPU's directly from selected banks at set rates rather than utilizing the more market driven auction procedure.⁸² For the period between September 15, 1997 and October 20, 1997, for example, while the one week JIBOR rate fluctuated between a high of 35.56% and a low of 21.38%, the one week SBPU rate was held steady by Bank Indonesia at 14.75%.⁸³

The types of measures taken by the Indonesian government to inject liquidity into the country's banks were neither new nor unusual. Actions such as adjusting interest rates, allocating state enterprise funds and balancing SBI sales against SBPU purchases are the usual instruments employed by Bank Indonesia to regulate the level of liquidity in the banking sector.

What was unusual in the wake of the Asian financial crisis was the degree to which these measures were relied on by the banking industry. The demands put on Bank Indonesia for liquidity support were enormous and unprecedented. In January 1998, for example, it is estimated that Bank Indonesia faced demands from

⁷⁹ See *id.*; see also Dan Murphy, *Indonesia Lets 70 Banks Borrow Money at SBPU Discount Window*, BLOOMBERG NEWS, Oct. 22, 1997, available in LEXIS, News Library, Allbnn File.

⁸⁰ See *Indonesia Monetary Policy*, *supra* note 51.

⁸¹ See *Banks on Life Support*, *supra* note 19. On the discounting of SBPU's, see *supra* text accompanying note 60.

⁸² See *Banks on Life Support*, *supra* note 19. In a government bill auction, participants are invited to submit bids for bills, and the price at which the bills are then sold, as well as the allocations of bills among participants, is based on the bids received.

⁸³ See Bloomberg News Service, *One Week JIBOR Rates*; Bloomberg News Service, *One Week SBPU Rates*.

banks for up to the rupiah equivalent of US\$500 million a day.⁸⁴ Because the Asian financial crisis essentially bankrupted most of the banking sector, the banks were wholly dependent on government support.⁸⁵ Rather than being used solely as a tool of monetary policy, liquidity support became the only means of solvency for the majority of the Indonesian banking system.⁸⁶

3. THE DEVELOPMENT OF A HIGHLY VULNERABLE BANKING SYSTEM

The Indonesian government began to deregulate the domestic banking industry in 1983,⁸⁷ but the most significant reforms were contained in a package promulgated by Bank Indonesia in 1988 and in a new banking law enacted in 1992.⁸⁸ Since this reform process was the subject of my 1995 article, I will not review the reforms again in detail in this Article. In general, the banking deregulation program in Indonesia involved opening up a previously state-bank-dominated sector to increased private competition and reducing direct government control over basic banking practices, such as the setting of interest rates and the allocation of loans.⁸⁹

In my 1995 article, I concluded that the Indonesian banking sector following deregulation had five dominant characteristics: (1) rapid credit growth; (2) the proliferation of a large number of poorly capitalized private banks; (3) increased competition among banks for customers; (4) significant over-exposure of banks to single customers and affiliated companies; and (5) a lack of adequate prudential standards and safeguards.⁹⁰ These characteristics sug-

⁸⁴ See *Waking Up*, *supra* note 19, at 47.

⁸⁵ See *Banks on Life Support*, *supra* note 19.

⁸⁶ See *id.*

⁸⁷ The 1983 reforms were enacted at a time when Indonesia's earnings from its principal export commodity, oil, were declining. In the two-year period, 1982 to 1983, for example, Indonesia's export earnings from oil fell by 24%. The Indonesian government recognized that a more efficient and well-developed banking system would help foster the creation of a more diversified national economy. The principal change affected by the 1983 reforms was the abolishment of Bank Indonesia control over interest rates on deposits and loans. See William Keeling, *Jakarta Struggles to Control Its Deregulation: Indonesia's Test of Economic Management May Have Just Begun*, FIN. TIMES, June 9, 1992, at 4.

⁸⁸ See *supra* text accompanying note 2.

⁸⁹ See Bennett, *supra* note 1, at 443.

⁹⁰ See *id.* at 470.

gest a banking system that was very susceptible to a downturn in the economy.

Because the fundamental business of banking exposes banks to both credit and market risks,⁹¹ the health of the banking industry in any country is dependent to a large extent on the general state of that country's economy. If general economic conditions deteriorate, in almost all cases, banking revenues and profits also will decline. However, some banks and banking systems, such as Indonesia's on the eve of the Asian financial crisis, are particularly vulnerable to economic downturns.

A bank that is poorly capitalized and has a highly concentrated loan portfolio, for example, stands a high risk of failing if any one or more of its largest borrowers defaults on its loans. When a banking system includes many such banks and, moreover, the system is characterized by rapid credit growth and tight competition that cause banks to lend increasingly larger amounts of money at increasingly smaller profit spreads,⁹² the banking system itself stands a high risk of failing. Any sharp decline in the economy that causes significant numbers of borrowers to become unable to service their loans could trigger a system-wide collapse.

Maintaining the long-term viability of such a banking system would require close supervision by regulators to ensure that banks were undertaking reasonably prudent risk management practices.⁹³ Through close supervision, regulators could, for example, require a bank to reduce its credit exposure to a borrower that was experiencing financial difficulties before those difficulties rose to a level that could threaten the bank's solvency. Such close regulatory supervision was completely lacking, however, in the Indonesian banking system following deregulation.⁹⁴

⁹¹ As used in this context, the term "credit risk" refers to the risk that a borrower will default on a loan while the term "market risk" refers to the risk that, due to changes in interest rates, foreign exchange rates, credit spreads or other market conditions, the value of a bank's assets will decline.

⁹² See Jathon Sapsford & Darren McDermott, *The Global Credit Crunch: Asian Retrenchment Is Penetrating Everywhere, Hindering Recovery*, ASIAN WALL ST. J., Oct. 8, 1998, at 1 (commenting that competition to lend to businesses in Indonesia and Thailand became so strong just prior to the Asian financial crisis that loan margins were often as low as one-tenth of the loan margins that were prevailing in 1993).

⁹³ See Wardhana, *supra* note 50.

⁹⁴ See *id.*

The regulatory framework of the banking system was underdeveloped and the regulators themselves were understaffed and poorly trained to provide adequate external supervision.⁹⁵ Because of the lack of both effective regulation and effective enforcement of what regulation did exist, Indonesian banks were given a high degree of autonomy to pursue risky lending practices.⁹⁶ Such lending practices are largely responsible for the fate of the Indonesian banking system in the wake of the Asian financial crisis.⁹⁷

In the case of the state-owned banks, risky lending practices were often the result of political pressure exerted by high ranking government officials on banks to make loans to certain borrowers.⁹⁸ The practice of making loans based on political pressure became known as "memo lending," because the loans were said to be extended based solely on a memo sent to the bank by a senior official or other influential person.⁹⁹ Memo lending led to high levels of non-performing loans at the state-owned banks for two related reasons.

First, as the prevalence of memo lending evidences, Indonesia's economy was characterized by high levels of cronyism and political patronage.¹⁰⁰ In such an environment, officials at the state-owned banks often viewed their job security and career advancement as being more dependent on their ability to satisfy political patrons than on their bank's financial performance.¹⁰¹ For a bank officer, satisfying political patrons generally involved financing the political patrons' favored companies and projects.¹⁰²

⁹⁵ See *id.*

⁹⁶ See *id.*

⁹⁷ See *id.*

⁹⁸ See, e.g., Tony Shale, *Mar'ie's Lone War Against Corruption*, EUROMONEY, Aug. 1994, at 20 [hereinafter *Mar'ie's Lone War*].

⁹⁹ See *id.* at 20.

¹⁰⁰ See *id.*; see also John McBeth, *Banking on Friends: Business and Politics Mix in Bapindo Case*, FAR E. ECON. REV., June 23, 1994, at 25-26; Manuela Saragosa, *'Favours' Blamed for Putting Indonesia in Second Division: Accusations of Politically Motivated Protection*, FIN. TIMES, Sept. 29, 1994, at 6; *World Bank Sets Up Corruption Teams for Indonesia, Paper Says*, BLOOMBERG NEWS, Sept. 15, 1998, available in LEXIS, News Library, Allbnn File. On the issue of corruption and economic development generally, see Cheryl W. Gray & Daniel Kaufmann, *Corruption and Development* (visited Jan. 21, 1999) <<http://www.worldbank.org/landd/english/0398/articles/020398/htm>>.

¹⁰¹ See McBeth, *supra* note 100, at 25-26.

¹⁰² See *Mar'ie's Lone War*, *supra* note 98, at 20.

Therefore, if a high-ranking official supported a loan being made to a certain borrower, a state-owned bank often would make that loan without employing proper due diligence techniques to assess the risk involved.¹⁰³

Second, borrowers often regarded loans extended by the state-owned banks with the support of a high-ranking patron as forms of governmental assistance, rather than as commercial obligations that needed to be repaid in full and on a timely basis.¹⁰⁴ Memo lending, therefore, resulted in many state-owned banks being saddled with loans made to companies of questionable creditworthiness that had no firm intention to repay.¹⁰⁵

In the case of the private banks, risky lending practices generally involved banks making loans to affiliated companies; the 1988 regulatory reforms, which substantially liberalized the requirements for establishing a new bank in the country, resulted in many of Indonesia's business conglomerates opening private banks.¹⁰⁶ These banks often were not managed on an independent basis, but rather were operated as captive funding sources for the conglomerate's businesses. In other words, such banks extended loans to affiliated companies to suit the funding needs of the conglomerate as a whole and on terms dictated by the conglomerate's senior officers rather than based on a prudent credit assessment of the individual borrowers.¹⁰⁷

Not surprisingly, conglomerates often used their private banks to fund affiliated companies and projects that were not sufficiently creditworthy to be able to borrow money from an unrelated third party lender.¹⁰⁸ Loans to affiliated companies, therefore, were often among the riskiest loans held by the private

¹⁰³ See *id.*; see also Goldstein, *supra* note 16.

¹⁰⁴ See Mar'ie's *Lone War*, *supra* note 98, at 20.

¹⁰⁵ See *id.*

¹⁰⁶ Chapter IV of the Banking Law authorizes the Minister of Finance to grant banking licenses, subject to certain requirements with respect to the organizational composition, capital, ownership and business plan of the applicant, as well as other matters. On the Banking Law generally, see William A. Sullivan, *International Banking: Indonesia*, INT'L FIN. L. REV., Sept. 1992, at 21.

¹⁰⁷ See *id.*

¹⁰⁸ See generally Jay Solomon, *Bank of Sinar Mas Group Shows Few Recovery Signs*, ASIAN WALL ST. J., Mar. 25, 1999, at 13 [hereinafter *Bank of Sinar Mas Group*].

banks.¹⁰⁹ In addition, the concentrated credit exposure that many of the private banks had to affiliated companies meant that those banks were exposed to the highly correlated risk that both their largest borrowers and their owners, since they were all in same corporate group, would experience financial difficulty at the same time.¹¹⁰ In other words, if affiliated borrowers began defaulting on their loans in large numbers, it was likely that the bank's owners would also be experiencing financial difficulty and would be unable to inject fresh capital into the bank to maintain its solvency.

The Indonesian government attempted to address the problem of excessive lending to affiliated companies in the Banking Law enacted in 1992.¹¹¹ The Banking Law contains provisions that restrict the aggregate amount that a bank may lend to affiliated companies to twenty percent of the bank's capital.¹¹² However, enforcement of those restrictions was generally quite lax and violations were rampant.¹¹³

Indonesian private banks used various means to fund affiliated companies in excess of the affiliate lending limits. The structures that banks used to conceal intra-group lending above the restrictions of the Banking Law varied depending on the degree of concern that a particular bank's management had that such excessive affiliate lending would be detected and sanctioned by bank regulators. In many cases, private banks simply underreported the loans that they made to affiliates.¹¹⁴ In other cases, banks used

¹⁰⁹ See generally *Indonesia Detains Two Bankers*, *supra* note 19; *Indonesia's Modern Group Pledges to Repay Debts*, BLOOMBERG NEWS, Sept. 11, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Modern Group Pledges*].

¹¹⁰ See generally *Indonesia Detains Two Bankers*, *supra* note 19; *Modern Group Pledges*, *supra* note 109.

¹¹¹ See generally Sullivan, *supra* note 106.

¹¹² See *Banking Industry*, *supra* note 35.

¹¹³ See Alistair Hammond, *Indonesia Says It May Take Over More Weak Banks*, BLOOMBERG NEWS, Sept. 29, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Indonesia Says*]. According to Bank Indonesia's figures, 51 banks violated the affiliate lending limits in 1997, an increase from 46 banks in 1996. See *Welcome to Bank Indonesia* (visited Jan. 21, 1999) <<http://www.bi.go.id/intl>>. Because of the various structures used to disguise intra-group lending, however, it is likely that Bank Indonesia's figures understate the extent of the violations of the affiliate lending limits.

¹¹⁴ See *Banking Industry*, *supra* note 35.

various conduits to channel funds indirectly to affiliated companies.¹¹⁵

The types of conduits used for this purpose included nonbank finance companies, unrelated companies that would receive a fee for their role in such transactions and special purpose vehicles setup by the bank or the borrower specifically to act as conduits.¹¹⁶ In the simplest conduit structure, a bank lends money to the conduit entity, which in turn lends that money to the bank's affiliate.¹¹⁷ The loan generally is nonrecourse to the conduit entity, with the conduit's only obligation being to pass on to the bank the interest and principal payments that it receives from the affiliate.¹¹⁸ The transaction is recorded in the bank's records as simply a loan to the conduit entity without any reference to the fact that the bank's ultimate credit exposure with respect to the loan is to an affiliate. Although use of some variation of this simple structure was not uncommon, more complex conduit structures also were developed to evade detection by bank regulators.¹¹⁹

¹¹⁵ This discussion on the use of conduits to fund affiliated companies in excess of the limits contained in the Banking Law is based on conversations that I have had with various Indonesian lawyers and bankers. See Interview, *supra* note 45.

¹¹⁶ See *id.*

¹¹⁷ See *id.*

¹¹⁸ A "nonrecourse" loan means that the lender does not have recourse to the general assets of the borrower to satisfy its claims in the event of a default. See BLACK'S LAW DICTIONARY 1057 (6th ed. 1990). In most conduit structures, the loan to the conduit ("Loan #1") is nonrecourse to the conduit but is secured by the conduit's rights in the loan made from the conduit to the affiliate ("Loan #2"). The conduit has an obligation to pay over to the bank under Loan #1 the payments that it receives from the affiliate under Loan #2. If the affiliate defaults, the conduit has no further payment obligations under Loan #1 and the bank can, pursuant to the security interest that it has in Loan #1, pursue the affiliate directly for payment. See Interview, *supra* note 45.

¹¹⁹ It should be noted that indirect lending to affiliated companies through conduits in excess of the affiliate lending limits is only arguably a violation of the Banking Law. See Interview, *supra* note 45. In general, Indonesian legal principles emphasize a relatively strict interpretation of code and regulatory provisions. Recharacterizing a transaction to emphasize its substance over its form or sanctioning an indirect violation of a regulation are not common legal concepts in Indonesia. With regard to the affiliate lending rules under the Banking Law, I have spoken with several Indonesian lawyers who take the position that, since indirect lending to affiliates through conduit structures is not covered expressly by the language of the Banking Law, such transactions are not subject to the affiliate lending limits. See *id.* Whether or not they constituted violations of the Banking Law, however, private banks generally at-

Certain private banks, for example, established a unit trust or other type of mutual fund in a tax haven jurisdiction.¹²⁰ The bank would then directly or indirectly purchase all the units of the fund and, in its capacity as sole owner of the fund's units, direct the fund to make investments in debt instruments issued by affiliated companies of the bank. Although only an investment in an offshore mutual fund would appear on the bank's balance sheet, the end effect of the fund making investments in debt instruments of affiliated companies was the same as if the bank had loaned money to such affiliates.¹²¹

Private banks also provided various types of credit support for loans made to affiliated companies by unrelated third party lenders.¹²² Based on such credit support, affiliated companies were able to obtain financing from outside sources that would not have been available based solely on the affiliate's own credit worthiness.¹²³ Although the provision of credit support by a bank for the benefit of an affiliated company did not violate the express terms of the affiliate lending limits, such transactions subverted the policy behind the lending limits by permitting banks to incur credit exposure to affiliates in excess of twenty percent of their share capital.¹²⁴

The types of credit support provided by private banks for their affiliates included direct loan guarantees, as well as more sophisticated financial instruments such as total return swaps and credit default swaps under which the risk on the loan was passed from the unrelated third party lender to the affiliated bank.¹²⁵

tempted to structure conduit transactions to avoid disclosure to, and detection by, regulators. *See id.*

¹²⁰ *See id.*

¹²¹ *See id.*

¹²² *See generally Bank of Sinar Mas Group, supra* note 108, at 13.

¹²³ *See id.*

¹²⁴ *See id.*

¹²⁵ To illustrate the use of total return swaps and credit default swaps for credit support purposes, assume that a bank ("Unrelated Bank") makes a loan (the "Loan") to a company (the "Borrower") affiliated with another bank ("Affiliated Bank"). In a total return swap, Unrelated Bank and Affiliated Bank enter into a swap agreement under which (a) Unrelated Bank pays to Affiliated Bank the interest and principal payments received on the Loan from the Borrower; and (b) Affiliated Bank pays to Unrelated Bank fixed or floating rate interest payments and the principal amount of the Loan on maturity. Such a swap agreement is referred to as a "total return swap" because Unrelated Bank is paying its "total return" on the Loan over to Affiliated Bank in exchange for

One attraction to banks of instruments such as swaps as opposed to direct guarantees was that, whereas guarantees are recorded in a designated place in a bank's financial statements, the accounting treatment for swaps is less well-defined.¹²⁶ In many cases, banks would simply set out the total aggregate notional amount of all of their swap positions in a footnote to their financial statements and not disclose any specific terms of such swaps.

The risky lending practices engaged in by Indonesian banks were not limited, however, to politically motivated loans by the state-owned banks and excessive intra-group lending by private banks. Indonesian banks also accumulated high risk loans simply by extending credit to companies and individuals without first obtaining sufficient information to assess the borrower's ability to repay.¹²⁷

In general, Indonesian companies did not adhere to international accounting standards or otherwise provide meaningful levels of financial disclosure with regard to their operations.¹²⁸ Because of this low level of corporate disclosure, Indonesian banks could rarely apply the risk-assessment techniques used by banks in more developed economies to decide whether to make a

certain payments from Affiliated Bank. The effect of such a total return swap transaction is to pass the risk on the Loan to Affiliated Bank, because any default on the Loan by Borrower will reduce the "total return" payments due from Unrelated Bank to Affiliated Bank under the swap agreement. In a credit default swap, Unrelated Bank and Affiliated Bank enter into a swap agreement under which (a) Unrelated Bank pays to Affiliated Bank a certain set amount; and (b) Affiliated Bank agrees that, if the Borrower defaults on the Loan, Affiliated Bank will pay Unrelated Bank an amount necessary to compensate Unrelated Bank for the loss incurred by Unrelated Bank with respect to the Loan. A credit default swap in this context is, therefore, equivalent to a guarantee of the Loan by Affiliated Bank (with the amount received by Affiliated Bank from Unrelated Bank under the swap agreement equivalent to a loan guarantee fee).

¹²⁶ See, e.g., S. Karene Witcher, *Hidden Loans, Derivatives Raise Cost of Indonesian Bank Bailout*, ASIAN WALL ST. J., June 25, 1998, at 1. On the general issue of the disclosure by banks of their derivatives positions see Basle Committee on Banking Supervision, *Survey of Disclosures about Trading and Derivatives Activities of Banks and Securities Firms 1997*, (visited Jan. 21, 1999) <<http://www.bis.org/publ/bcbs44.htm>> [hereinafter BIS Homepage].

¹²⁷ See Wardhana, *supra* note 50.

¹²⁸ See *id.* For a discussion of Asia's generally poor accounting standards, see James T. Aredy, *Accountants Are in the Spotlight of Asian Crisis*, ASIAN WALL ST. J., Oct. 26, 1998, at 4.

loan.¹²⁹ Unable to exercise financial due diligence when making lending decisions, banks often were left to rely on the reputation of a company, its physically apparent traits such as the number and quality of its properties, or, in some cases, even less reliable indicators of a prospective borrower's financial health, such as the size of the company president's home or the make of his or her car.¹³⁰

The extremely low capitalization of the great majority of the country's banks magnified the systemic risk to the banking system posed by these types of lending practices. The Banking Law enacted in 1992 set the minimum paid-in capital requirement for newly established banks at only the then rupiah equivalent of roughly US\$5 million.¹³¹ This minimum capital requirement was very low by international standards. By comparison, when Taiwan deregulated its banking system in 1989 to permit the establishment of private banks, Taiwan's government set the minimum paid-in capital requirement at approximately US\$370 million.¹³²

Although most of Indonesia's banks had a higher capitalization than the statutory minimum set by the Banking Law, only a few of the country's largest banks were capitalized at or above US\$500 million prior to the Asian financial crisis.¹³³ The major-

¹²⁹ See Todd Eastham & Alistair Hammond, *Indonesia's Subianto Faults Bankers for Indiscriminate Lending*, BLOOMBERG NEWS, Oct. 4, 1998, available in LEXIS, News Library, Allbnn File.

¹³⁰ See Wardhana, *supra* note 50; see also Eastman & Hammond, *supra* note 129 ("Yet in many countries, including Indonesia, the lack of information meant investors made decisions 'more on the basis of market sentiment and less on objective information' . . .") (citation omitted).

¹³¹ The minimum paid-in capital requirement was set at IDR 10 billion. In September 1995, however, Bank Indonesia raised the minimum capital requirement for state-owned banks to IDR 1 trillion and announced that all banks with foreign exchange licenses would be required to increase their paid-in capital to at least IDR 150 billion by September 22, 2001. See Standard & Poor's Creditwire on Indonesia, *supra* note 33.

¹³² See Lawrence S. Liu, *Financial Developments and Foreign Investment Strategies in Taiwan—A Legal and Policy Perspective*, 25 INT'L LAW. 69, 83 (1991).

¹³³ Based on 1996 and 1997 figures, only nine Indonesian banks had share capital of US\$500 million or more. See Brian Caplen, *All Set for Recovery*, EUROMONEY, Aug. 1998, at 79 [hereinafter *Set for Recovery*]. These included Bank Danamon Indonesia, Bank Rakyat Indonesia, Bank Central Asia, Bank Negara Indonesia, Bank Dagang Negara, Bank Bumi Daya, Bank Ekspor Impor Indonesia, Bank Internasional Indonesia, and Bank Tabungan Negara. See *id.*

ity of the country's more than 200 banks, in contrast, had well under US\$100 million of paid-in capital, meaning that the Indonesian banking sector had an extremely small capital base by developed economy standards,¹³⁴ and a marginal to weak capital base by emerging market economy standards.¹³⁵

On the eve of the Asian financial crisis, therefore, the Indonesian banking sector appeared relatively vibrant in terms of credit growth and competition, but it had an inherently weak core. The banking industry consisted of a large number of poorly capitalized banks that engaged in risky lending practices which caused a high percentage of their loans to become non-performing.¹³⁶ These weaknesses, however, did not appear suddenly in 1997. They had developed and deepened over many years as the direct result of the Indonesian government deregulating the banking system without simultaneously installing adequate mechanisms for the prudential supervision of banks.¹³⁷

The lack of effective regulatory scrutiny of banking transactions gave banks substantial discretion to assess and manage risks as they saw fit.¹³⁸ Bankers also had little reason to believe that regulators would detect or punish violations of banking regulations.¹³⁹ This discretion and lack of accountability led to the proliferation of the types of risky banking practices described above.¹⁴⁰

¹³⁴ In a list of the world's 200 largest banks by share capital published in June 1998, the list identified the five largest banks (with their country of establishment and capitalization) as: (1) Hong Kong Shanghai Banking Corporation Holdings (United Kingdom), US\$30.8 billion; (2) Bank of Tokyo-Mitsubishi (Japan), US\$24.7 billion; (3) ING Group (The Netherlands), US\$23.8 billion; (4) Cr dit Agricole (France), US\$22.7 billion; and (5) The Chase Manhattan Bank (United States) US\$21.7 billion. See *Bank Atlas*, EUROMONEY, June 1998, at 157. Even the 200th largest bank on the list, Natexis of France, had share capital of US\$1.7 billion. See *id.* at 162.

¹³⁵ In a list of the largest emerging market banks compiled in 1998 by the international credit rating agency Fitch IBCA, none of the top 50 banks had share capital of less than US\$1 billion. See *Set for Recovery*, *supra* note 132.

¹³⁶ By October 1998, authorities estimated that more than 50% of the loans in the Indonesian banking system were non-performing. See *Agency Cuts Ratings of Banks in Indonesia*, ASIAN WALL ST. J., Oct. 8, 1998, at 22.

¹³⁷ See Goldstein, *supra* note 16.

¹³⁸ See *id.*

¹³⁹ See *id.*

¹⁴⁰ See *id.*

The tendency of banks operating in poorly regulated environments to engage in unsound lending practices and to take on unsustainably high levels of risk is often discussed in terms of "moral hazard."¹⁴¹ In this context, the expression "moral hazard" refers to the theory that excessive risk-taking by banks is encouraged by the perception, whether or not grounded in actual government policy, that a government will not permit banks to fail because of their importance to a country's economy.¹⁴²

Moral hazard may have played a part in the risky lending practices pursued by many Indonesian banks. For example, precedents of the Indonesian government supporting banks in financial difficulties may have led Indonesian bankers to believe that the government would never permit a bank failure.¹⁴³ In 1991, for instance, the government injected new capital into Bank Danamon when the bank faced large-scale depositor withdrawals caused by rumors that it either was, or was soon to be, insolvent.¹⁴⁴

However, the moral hazard theory is at most only a partial explanation for the generally poor quality of the nation's banks' loan portfolios. Risky loans also accumulated because lending decisions were often made for reasons other than the best interests of the bank. As described above, in the case of the state-owned banks, banks frequently extended loans to satisfy political patrons and, in the case of the private banks, banks often made loans to finance affiliated companies that were not sufficiently credit wor-

¹⁴¹ See Ha-Joon Chang, *The Hazard of Moral Hazard*, FIN. TIMES, Oct. 7, 1998, at 19 (describing "moral hazard" as the result of government guarantees over firms and banks, which leads to risky and inefficient investments).

¹⁴² See Goldstein, *supra* note 16 (describing the "moral hazard" argument as the provision of insurance by the official sector that acts as a subsidy to risk taking and results in too many resources being channeled into insured activities); Wardhana, *supra* note 50. But see Chang, *supra* note 141, at 19 (stating that the moral hazard explanation is relied on too frequently by analysts and does not adequately explain the banking crises that occurred in connection with the Asian financial crisis). The expression "moral hazard" is also used in analyses of the Asian financial crisis to refer to the theory that foreign banks lending to Indonesia did not adequately assess the risks of such investments because they believed that their governments, or multi-national organizations such as the International Monetary Fund, would ensure that they did not suffer any significant losses. See, e.g., Krugman, *supra* note 16 (describing how "moral hazard" has led to overinvestment in Asia).

¹⁴³ See Wardhana, *supra* note 50.

¹⁴⁴ See *id.*

thy to borrow from unrelated third parties.¹⁴⁵ Such conflicts of interest occurred because of the lack of effective banking supervision.¹⁴⁶

Furthermore, by failing to closely supervise the banking sector, Indonesian regulators did not gain a complete and accurate assessment of the dangerously weak financial condition of the country's banks. Regulators did not have any type of early warning system to alert them of potential solvency problems within the banking system in sufficient time to take remedial action. As a result, the regulators did not begin to take concerted steps to address the weaknesses in the banking system until the system was on the verge of collapse in connection with the Asian financial crisis.

4. THE INDONESIAN GOVERNMENT'S RESPONSE TO THE BANKING CRISIS

As described in Section 2 of this Article, the Indonesian government's initial response to the severe liquidity problems faced by Indonesian banks in the wake of the Asian financial crisis was to rely on its usual monetary policy tools. Beginning in September 1997, the government began injecting substantial liquidity into the banking system by lowering interest rates, depositing state-owned enterprise funds into selected banks and re-opening its government bill discount facilities.¹⁴⁷

Such measures proved to be insufficient to stabilize the banking sector. Although Bank Indonesia's policies succeeded in preventing a system-wide collapse, the continued solvency of many Indonesian banks became wholly dependent on receiving increasingly larger amounts of liquidity support.¹⁴⁸ As the negative balances that such banks maintained with Bank Indonesia grew steadily larger, the government was threatened with the likelihood that maintaining banking liquidity through monetary policy tools alone would put an unsustainable burden on its resources.¹⁴⁹ Faced with that likelihood and under pressure from

¹⁴⁵ See Alistair Hammond & Dan Murphy, *Indonesia's Banks Get Pushed to the Brink: Industry Spotlight*, BLOOMBERG NEWS, Nov. 17, 1997, available in LEXIS, News Library, Allbnn File [hereinafter *Pushed to the Brink*].

¹⁴⁶ See *id.*

¹⁴⁷ See *Indonesia Monetary Policy*, *supra* note 51.

¹⁴⁸ See *id.*

¹⁴⁹ See *id.*

the International Monetary Fund to demonstrate that it was serious about banking reform,¹⁵⁰ the Indonesian government changed course in November 1997 from addressing the problems in the banking sector solely with monetary policy adjustments to pursuing a fundamental restructuring of the banking system itself.¹⁵¹

On November 1, 1997, the Indonesian government took its first significant step toward restructuring the banking sector when it announced the liquidation of sixteen of the weakest private banks.¹⁵² The government decided to liquidate the banks in response to a rash of depositor withdrawals occurring at a number of private banks, which threatened to become a full-scale run on the banking system as a whole.¹⁵³ The closure of the banks was part of a government effort to prevent such a run by restoring public confidence in the banking system. The government intended the action to be interpreted by the public as an affirmative endorsement that banks not selected for liquidation were sound.¹⁵⁴

Together with the liquidation of the sixteen banks, the Indonesian government also attempted to bolster public confidence in the banking sector by announcing a limited deposit protection scheme for depositors in the closed banks.¹⁵⁵ Under the program, the government guaranteed that all deposits of 20 million rupiah or less would be repaid in full.¹⁵⁶ All deposits above that threshold amount, as well as the claims of other creditors of the closed

¹⁵⁰ The International Monetary Fund attached progress on bank reform as a condition to the disbursement of financial assistance to Indonesia. See Dan Murphy & Andi Asrun, *Indonesia Shuts 16 Banks after \$23 Bln IMF Package*, BLOOMBERG NEWS, Nov. 1, 1997, available in LEXIS, News Library, Allbnn File (indicating that Indonesia would receive assistance in exchange for its pledge to restructure its banking industry and to conduct economic reform).

¹⁵¹ See *Indonesia Monetary Policy*, *supra* note 51.

¹⁵² See *id.*; see also *List of 16 Banks*, *supra* note 25.

¹⁵³ See *Waking Up*, *supra* note 19; *Goeltom Interview*, *supra* note 62; see also Murphy & Asrun, *supra* note 150.

¹⁵⁴ See Murphy & Asrun, *supra* note 150.

¹⁵⁵ See *id.*

¹⁵⁶ See *id.* Based on the USD-IDR foreign exchange rate on November 1, 1997, this threshold amount was the equivalent of approximately US\$5,700. See *id.* In the aggregate, the government guaranteed approximately 2.3 trillion rupiah (US\$657 million) under the deposit protection scheme. See *id.*

banks, were to be repaid, to the extent funds were available, from the sale of the banks' assets.¹⁵⁷

The International Monetary Fund saw the forced liquidation of the sixteen banks as a sufficiently important first step toward restructuring the banking system and thus rewarded the Indonesian government with the release of the first installment of the promised aid package.¹⁵⁸ Many analysts also saw the closure of the banks as a positive development for Indonesian banking reform, because the list of owners of the banks selected for closure included people with strong political connections, including several members of the family of then-President Suharto.¹⁵⁹ For example, one of Suharto's sons, Bambang Trihatmodjo, partly owned one of the closed banks, Bank Andromeda, and Suharto's half-brother Probosutejo, partly owned another, Bank Jakarta.¹⁶⁰ The closure of these banks suggested that Bank Indonesia was willing to confront some of the most powerfully vested interests in the country.¹⁶¹

Other analysts, however, pointed out that the banks selected for liquidation were among the smallest and weakest in the coun-

¹⁵⁷ See Murphy & Asrun, *supra* note 150 ("The money to pay larger depositors and inter-bank creditors will be raised from the sale of the banks' assets.").

¹⁵⁸ See International Monetary Fund, *IMF Approves Stand-By Credit for Indonesia*, (last modified Nov. 5, 1997) <<http://imfint1x.imf.org:80/external/np/sec/pr/1997/PR9750.htm>>.

¹⁵⁹ For a discussion of the significant business interests held by members of the Suharto family, see Philip Shenon, *For Asian Nation's First Family, Financial Empire Is in Peril*, N.Y. TIMES, Jan. 16, 1998, at A1. Suharto resigned as President of Indonesia on May 21, 1998. See Keith B. Richburg, *Suharto Steps Down, Names Successor*, WASH. POST, May 21, 1998, at A1.

¹⁶⁰ See *Real Crisis*, *supra* note 36. Bambang Trihatmodjo waged an ultimately unsuccessful fight against the closure of Bank Andromeda, which included filing a lawsuit against the Minister of Finance and the Governor of Bank Indonesia. See Dan Murphy et al., *Suharto Son Sues Reformers; Indonesia Reform in Doubt*, BLOOMBERG NEWS, Nov. 5, 1997, available in LEXIS, News Library, Allbnn File [hereinafter *Suharto Son Sues*]. Although Trihatmodjo admitted that Bank Andromeda loaned an amount in excess of 20% of its share capital to an affiliated company, he claimed that the government unfairly singled out Bank Andromeda for liquidation since, as he claimed, more than 90% of the country banks also violated the affiliate lending limits. See *id.*; *Pushed to the Brink*, *supra* note 145.

¹⁶¹ See *Suharto Son Sues*, *supra* note 160 (describing the need not to give in to protesters' demands in stating "[b]acktracking of any kind on the closure of Bank Andromeda or other banks would highlight that political interests still block much-needed efforts to reform the economy . . .").

try and that their closure would not have a significant impact on the health of the banking system as a whole.¹⁶² In the aggregate, the assets of the closed banks accounted for “less than 3.5% of Indonesia’s total banking assets.”¹⁶³

Although the government intended the closure of the sixteen banks as a confidence building measure, the action had the opposite effect on public opinion in Indonesia. Rather than restoring confidence in the banking system, the closures intensified the movement of funds out of the smaller private banks as depositors worried that their own banks would be in the next wave of institutions to be liquidated.¹⁶⁴ The Governor of Bank Indonesia reacted to the continued withdrawals from the private banks by declaring, within a few days of the original liquidation announcement, that no further banks would be closed.¹⁶⁵ Such promises were not sufficient, however, to stem the flow of money out of the smaller banks.¹⁶⁶

The Indonesian government took its next major policy actions with respect to banking reform in January 1998. On January 27, the government announced that it would guarantee the rupiah and foreign currency denominated debts of all domestically incorporated banks.¹⁶⁷ This guarantee was substantially

¹⁶² See Daniel Moss & Christopher Donville, *Asia Lurches Toward Banking Reform as Economic Miracle Fades*, BLOOMBERG NEWS, Nov. 13, 1997, available in LEXIS, News Library, Allbnn File.

¹⁶³ *Id.*

¹⁶⁴ See, e.g., *Goeltom Interview*, *supra* note 62 (describing her opinions on the effects of Bank Indonesia’s actions); Claire Low et al., *Indonesia’s BCA Faces Run; Speculation of Liem Death Denied*, BLOOMBERG NEWS, Nov. 14, 1997, available in LEXIS, News Library, Allbnn File (reporting on bank runs at two branches of Bank Central Asia).

¹⁶⁵ See Alistair Hammond, *Indonesian Central Bank Governor Says No More Bank Closures*, BLOOMBERG NEWS, Nov. 3, 1997, available in LEXIS, News Library, Allbnn File. On later attempts by Bank Indonesia to maintain confidence in the banking sector, see Bank Indonesia, *Press Release on BI Rebuttal on Rumors* (visited Feb. 4, 1999) <<http://www.bi.go.id/intl/press/3017pr1997.htm>>.

¹⁶⁶ See *Waking Up*, *supra* note 19.

¹⁶⁷ See *Republic of Indonesia Presidential Decree No. 26/1998*, Jan. 26, 1998 (concerning the Guarantee of Commercial Bank Obligations). Separate from the guarantee program, in July and August 1998, the Indonesian government carried out an exchange offer of certain foreign currency denominated debt of the Indonesian banks. Under the exchange offer, foreign creditors were permitted to exchange eligible Indonesian bank debt for new loans guaranteed by Bank Indonesia. Approximately US\$2.7 billion of debt was tendered in the exchange offer. See Minerva Lau & Chris McAllum, *Indonesia Pushes Forward*

more comprehensive than the limited deposit protection scheme that was introduced in connection with the liquidation of the sixteen banks in November 1997. The guarantee extended to deposits and most types of creditor claims, other than subordinated loans and debts to shareholders or affiliated entities, including debts incurred by banks' overseas branches.¹⁶⁸ Intended as a relatively short-term measure to restore confidence in the banking sector, the guarantee was due to expire on January 31, 2000.¹⁶⁹ The Indonesian government announced that at that time the guarantee could be replaced, in part, by a deposit insurance scheme.¹⁷⁰

Banks subject to the guarantee program were required to pay a semi-annual guarantee fee to the Indonesian government.¹⁷¹ The government set the amount of the initial guarantee fee for each bank at 0.25% of the bank's average monthly amount of the debts guaranteed under the program.¹⁷² The obligation to pay the fee was secured by a kind of lien on each bank's assets in favor of the government; thus, banks were restricted from paying any cash dividends to their shareholders unless they were current with all of their payment obligations to the government, including guarantee fees.¹⁷³ To prevent an uncontrolled increase in the amount of debts subject to the guarantee, Bank Indonesia also placed restrictions on credit growth and set weekly ceilings on the maximum interest rates that banks could pay on deposits.¹⁷⁴

On January 27, 1998, in addition to the guarantee program, the Indonesian government also announced the creation of a new

Restructuring, 1242 INT'L FINANCING REV. 77, 77 (1998); Bank Indonesia, *Indonesian Interbank Exchange Offer Expected to Proceed on Schedule*, BLOOMBERG NEWS, Aug. 13, 1998, available in LEXIS, News Library, Allbnn File; Robert Rice, *The International Rescue Packagers*, FIN. TIMES, Aug. 4, 1998, at 13.

¹⁶⁸ See Bank Indonesia, *Implementing Guidelines for the Government Guarantee Program on Commercial Bank Obligations*, BLOOMBERG NEWS, Mar. 6, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Bank Guarantee Implementing Guidelines*].

¹⁶⁹ See *id.*

¹⁷⁰ See Bank Indonesia, *Statement from Bank Indonesia's Governor Soedradjad Djiwandono*, BLOOMBERG NEWS, Jan. 27, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Bank Indonesia January 27 Press Release*]; see also *Welcome to Bank Indonesia*, *supra* note 113.

¹⁷¹ See *Bank Guarantee Implementing Guidelines*, *supra* note 168.

¹⁷² See *id.*

¹⁷³ See *id.*

¹⁷⁴ See *Bank Indonesia January 27 Press Release*, *supra* note 170.

regulatory body for the banking industry known as the Indonesian Bank Restructuring Agency ("IBRA").¹⁷⁵ A presidential decree established the IBRA as an independent agency reporting to the Ministry of Finance, with the intention that it would have a limited lifespan and would be disbanded once the restructuring of the country's banking system was deemed complete.¹⁷⁶ The new agency was staffed primarily by secondees from Bank Indonesia and the Indonesian Ministry of Finance.¹⁷⁷ It also appointed the New York-based investment banks Lehman Brothers and JP Morgan to act as its advisers.¹⁷⁸

The government gave IBRA a four-pronged mandate. First, it was assigned overall responsibility for managing the process of restructuring the bank sector, including assuming management control over those banks judged too financially weak to be rehabilitated under their existing management.¹⁷⁹ Second, it was put in charge of administering the government's guarantee program for bank debts.¹⁸⁰ Third, it was empowered to establish a separate asset management entity to be known as the Asset Management Unit ("AMU") to take over non-performing assets from banks that were either to be liquidated or merged into stronger institutions.¹⁸¹ Fourth, it was appointed as a kind of collection agent for the government, with responsibility for collecting from the majority shareholders of the private banks the amounts that their banks owed Bank Indonesia in connection with the liquidity support that they had received.¹⁸²

The establishment of the IBRA was largely a result of pressure from the International Monetary Fund on the Indonesian gov-

¹⁷⁵ See *id.* The IBRA is known in Bahasa Indonesia as Badan Penyehatan Perbankan Nasional or the BPPN. For general information on the IBRA, see IBRA, *Who Is IBRA?* (visited Jan. 27, 1999) <<http://www.indoexchange.com/bagong/general/bppn/who/tengah.html>> [hereinafter *Who Is IBRA?*].

¹⁷⁶ See *Republic of Indonesia Presidential Decree No. 27/1998*, Jan. 26, 1998 (concerning the Establishment of the Indonesian Bank Restructuring Agency/IBRA).

¹⁷⁷ See *Bank Indonesia January 27 Press Release*, *supra* note 170.

¹⁷⁸ See *IBRA Advisory Mandate*, 1242 INT'L FINANCING REV. 78 (1998).

¹⁷⁹ See International Monetary Fund, *Camdessus Welcomes Indonesia's Measures*, BLOOMBERG NEWS, Jan. 26, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Camdessus Welcomes Measures*].

¹⁸⁰ See Rice, *supra* note 167.

¹⁸¹ See *Bank Indonesia January 27 Press Release*, *supra* note 170.

¹⁸² See *Who Is IBRA?*, *supra* note 175.

ernment to prove that it was making progress on bank reform.¹⁸³ However, one could interpret the creation of a new regulatory body for the banking industry as an acknowledgment by the government of both the severity of the problems facing the banking sector and the failings of Bank Indonesia. Prior to the creation of the IBRA, Bank Indonesia was the primary supervisory body for the banking industry.¹⁸⁴ Bank Indonesia bore much of the responsibility, therefore, for the government's failure to adequately supervise the country's banks and the resulting vulnerability of the banking sector to the Asian financial crisis. Bank Indonesia also may have been too tainted by allegations of corruption and general complicity with earlier wrong-doing by the country's banks to serve as an effective focal point for the reform of the banking system.¹⁸⁵

As part of its supervisory role, the IBRA undertook a review, in conjunction with Bank Indonesia, of the financial position of each of the country's banks.¹⁸⁶ Based on that review, it divided banks that had received substantial liquidity support from Bank Indonesia, defined as more than 500% of their total equity, into two categories: Category A and Category B.¹⁸⁷ Category A banks had received liquidity support equal to or in excess of 75% of their total assets and Category B banks had received less liquidity support than the 75% threshold, but still equal to or in excess of two trillion rupiah.¹⁸⁸ Category A banks were to be liquidated, whereas Category B banks were to have their existing managers replaced by the IBRA until full control over the banks could be transferred to a state-owned financial institution.¹⁸⁹

¹⁸³ See Witcher, *supra* note 126; see also Camdessus Welcomes Measures, *supra* note 179 (stating the International Monetary Fund's Managing Director's praise of the program).

¹⁸⁴ See Sullivan, *supra* note 106, at 21.

¹⁸⁵ On allegations of corruption involving Bank Indonesia, see, for example, Alistair Hammond, *Four Former Bank Indonesia Directors Were Fired for Corruption*, BLOOMBERG NEWS, Dec. 27, 1997, available in LEXIS, News Library, Allbnn File.

¹⁸⁶ See *Who Is IBRA?*, *supra* note 175.

¹⁸⁷ See *id.*

¹⁸⁸ See *id.*

¹⁸⁹ See *id.*

Applying such criteria, by August 1998, the IBRA had taken action against fourteen banks.¹⁹⁰ The new agency identified ten banks as Category A banks and suspended their operations.¹⁹¹ The assets of those banks were liquidated by transferring deposit accounts and performing assets to other banks under IBRA administration and transferring non-performing assets to the AMU.¹⁹² The IBRA also identified another four banks, Bank Central Asia, Bank Danamon, Bank PDFCI and Bank Tiara Asia, as Category B banks. The IBRA effectively nationalized the Category B banks, by suspending the rights of their shareholders and officers and assuming management control.¹⁹³

The IBRA demanded that the former majority shareholders of the suspended and nationalized banks pay the government two separate amounts; first, the outstanding negative balance that their respective bank had accumulated with Bank Indonesia, and second, the amount by which their respective banks' intra-group lending exceeded the affiliate lending limits.¹⁹⁴ In the case of most of the banks, both amounts were quite substantial. Each of the banks owed Bank Indonesia more than 500% of its total share capital.¹⁹⁵ More than 80% of Bank Umum Nasional's loan portfolio

¹⁹⁰ See Bank Indonesia, *Bank Indonesia: Banking Restructuring and Resolution*, BLOOMBERG NEWS, Aug. 23, 1998, available in LEXIS, News Library, Allbnn File.

¹⁹¹ The operations of seven banks, Bank Surya, Bank Subentra, Bank Kredit Asia (also known as Istismarat), Bank Pelita, Hokindo Bank, Deka Bank and Centris International Bank were suspended in April 1998 and the operations of another three banks, Bank Dagang Nasional Indonesia (known by its acronym "BDNI"), Bank Umum Nasional and Bank Modern were suspended in August 1998. See Bank Indonesia, *Bank Indonesia: Banking Restructuring and Resolution*, BLOOMBERG NEWS, Aug. 23, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Bank Indonesia August 24 Press Release*]; *Indonesia: Bank Repayments*, *supra* note 26. On the suspension of the seven banks in April 1998, see also Ministry of Finance, *Announcements: Regulatory Agency BPPN Invokes Government Guarantee Program to Safeguard Depositors*, (visited Feb. 12, 1999) <<http://www.indoexchange.com/bagong/general/bppn/announcements/25abtoc.htm>> (discussing the freezing of operations of seven banks and placement of seven others under BPPN management control).

¹⁹² See *Uncertainty Looms Over Indonesian Banks*, *supra* note 26.

¹⁹³ See *id.*; see also S. Karene Witcher & Jay Solomon, *Jakarta Takes Over Much of Bank System*, ASIAN WALL ST. J., Aug. 24, 1998, at 1 (discussing the takeover of the PT Bank Central Asia and other banks).

¹⁹⁴ See *id.*

¹⁹⁵ See generally *Who Is IBRA?*, *supra* note 175.

lio, for example, was reported to have consisted of loans made to affiliated companies.¹⁹⁶

The IBRA used the threat of criminal prosecution to compel the owners of the suspended and nationalized banks to make the required payments.¹⁹⁷ The credibility of that threat was reinforced by the Indonesian police, which issued an order prohibiting any of the majority shareholders or directors of the banks being liquidated by the IBRA from leaving the country.¹⁹⁸ The police also named more than twenty executives from the liquidated banks as suspects in a criminal investigation of violations of the affiliate lending rules.¹⁹⁹ Further pressure was provided when the Indonesian government empowered the IBRA to seize the personal assets of bank owners who failed to make timely payments.²⁰⁰

The IBRA originally set a deadline of September 21, 1998 for such payment.²⁰¹ However, when the former owners of only three banks had substantially complied by that date, the deadline was extended first by one month and then by one year to September 1999.²⁰² Initially, the owners of the failed banks pledged various assets to the IBRA, such as property and company shares, rather than cash to fulfill their obligations.²⁰³ The pledged assets

¹⁹⁶ See *id.*

¹⁹⁷ See *id.*

¹⁹⁸ See *Indonesia: Bank Repayments*, *supra* note 26.

¹⁹⁹ See *id.*; see also *Indonesia Detains Two Bankers*, *supra* note 19 (discussing the banking probe and its effect on certain individuals); Alistair Hammond, *Indonesia Names 29 Bankers as Suspects in Criminal Probe*, BLOOMBERG NEWS, Aug. 19, 1998, available in LEXIS, News Library, Allbnn File (discussing those who were and were not named as suspects). The Indonesian government has suggested that bank owners who fail to repay the government could be subject to extremely serious punishments, including sentences of up to twenty years in prison and the death penalty. See Jason Singer, *Indonesia to Use Death Penalty Against Late Payers*, SCMP Says, BLOOMBERG NEWS, Oct. 15, 1998, available in LEXIS, News Library, Allbnn File.

²⁰⁰ See *Indonesia: Bank Repayments*, *supra* note 26; Dan Murphy & Daniel Moss, *Indonesian Gov't Shuts 3 Banks, Seizes 4 Others*, BLOOMBERG NEWS, Aug. 21, 1998, available in LEXIS, News Library, Allbnn File.

²⁰¹ See Witcher & Solomon, *supra* note 193.

²⁰² The banks that reached substantial agreement with the IBRA regarding the payment of these amounts by the original September 21, 1998 deadline were Bank Central Asia, BDNI and Bank Surya. See Adam Schwartz, *Perils of Restructuring Indonesia*, ASIAN WALL ST. J., Oct. 12, 1998, at 8 [hereinafter *Perils of Restructuring*].

²⁰³ See Jay Solomon, *Salim, Gajah Tunggal Agree to Transfer Assets to Pay Debts*, ASIAN WALL ST. J., Sept. 28, 1998, at 6.

included equity holdings in companies in industries ranging from food to mining to property.²⁰⁴ Because of the difficulties in evaluating such assets, however, the IBRA announced in late September 1998 that in the future it would accept only cash as payment.²⁰⁵

The transfer of assets to the IBRA by the former controlling shareholders of the liquidated and nationalized banks, together with the AMU's acquisition of non-performing loans, represented the transfer of a significant portion of the Indonesian economy from private to state control.²⁰⁶ In addition to holding loans and other types of traditional banking assets, the government became a major shareholder in many of Indonesia's largest listed companies. These holdings included more than ten percent of the shares of the country's largest automotive parts assembler, Astra International, and more than thirty percent of its largest cement producer, Indocement.²⁰⁷ The government acquired such a substantial amount of property in connection with the bank restructuring process that the question of how best to manage, and ultimately dispose of, the various assets became a significant issue for the regulators.²⁰⁸

As of October 1998, the government intended to sell many of the physical assets that it acquired from the failed banks, such as buildings, company automobiles and office furniture and fixtures, by means of public auctions.²⁰⁹ Disposing of financial assets, such

²⁰⁴ See *id.*; *Indonesian Banks: Repayment Terms*, ECONOMIST, Sept. 26, 1998, at 77; Andi Asrun & Dan Murphy, *Owners of 14 Indonesian Banks Say They've Covered Their Debts*, BLOOMBERG NEWS, Sept. 21, 1998, available in LEXIS, News Library, Allbnn File.

²⁰⁵ See *Perils of Restructuring*, *supra* note 202; see generally *Indonesia Says, supra* note 113 (discussing continuing IBRA bank takeovers and Indonesian efforts to recover money owed by banks).

²⁰⁶ See Witcher & Solomon, *supra* note 193.

²⁰⁷ Shares in these companies were transferred to the IBRA by the Salim Group, the controlling shareholders of Bank Central Asia. The government's 30% holdings in Indocement (PT Indocement Tunggal Prakasa) also included, however, a 20% stake that the government had acquired in 1985 as part of a government loan package to the company. See Jay Solomon & Richard Bor-suk, *Holding Company to Get Salim Stakes*, ASIAN WALL ST. J., Sept. 21, 1998, at 1.

²⁰⁸ See Andi Asrun & Dan Murphy, *Owners of 14 Indonesian Banks Say They've Covered Their Debts*, BLOOMBERG NEWS, Sept. 21, 1998, available in LEXIS, News Library, Allbnn File.

²⁰⁹ See Kate Linebaugh, *Indonesia to Auction Bank Assets*, ASIAN WALL ST. J., Oct. 15, 1998, at 3.

as loans and securities, however, posed more difficult problems, both with regard to valuing such assets and identifying prospective purchasers. The types of financial assets held by the government were particularly difficult to value because many were non-performing loans and other types of defaulted debt instruments.²¹⁰ Determining the fair market value of non-performing assets requires an analysis of the probability either that the borrower will begin to repay or that the holder otherwise will be able to collect some amount from the borrower by taking enforcement action. Undertaking such an analysis in Indonesia in 1998 was little more than guesswork because of the uncertain economic environment as well as the lack of effective legal methods for creditors to enforce on payment claims.

The difficulty for the Indonesian government in disposing of financial assets was further compounded by the general economic distress in the country caused by the Asian financial crisis. Trading on the Jakarta Stock Exchange, for example, was generally so volatile, and volumes were so thin, that it was virtually impossible for the government to dispose of large blocks of shares without causing a significant decline in their price.²¹¹ Moreover, Indonesian companies and wealthy individuals, who would ordinarily constitute the primary market for domestic Indonesian assets, generally were too cash poor to make new investments.²¹²

The government also faced difficulties selling assets to foreign investors.²¹³ Although the devaluation of the rupiah made Indonesian assets relatively inexpensive for investors holding relatively strong currencies, such as U.S. dollars, Japanese yen or German marks, the problems of determining an accurate value for the types of financial assets held by the government was particularly acute for foreigners.²¹⁴ The documentation relating to the assets

²¹⁰ See generally *id.*

²¹¹ See generally *Indonesia Exchange Homepage*, *supra* note 26.

²¹² See generally *id.*

²¹³ See Anne Segall, *City: The Flight of the Humble Rupiah Leaves Asia with a Nasty Sting*, DAILY TELEGRAPH, Feb. 2, 1998, available in 1998 WL 2994240.

²¹⁴ Although most foreign fund managers did not have the ability to evaluate Indonesian assets, such as non-performing loans, several specialist investment funds were set up in 1997 and 1998 specifically to take advantage of the sharp devaluation of Asian assets caused by the Asian financial crisis. These funds, often referred to as Asian "vulture funds," looked to benefit from the devalued currencies and distressed market conditions in Asia to purchase assets at unusually low prices. See, e.g., *Greenwich Group Matches U.S. Funds to Hong*

generally was written in Bahasa Indonesia and, even more prohibitively for foreign investors, an accurate picture of the financial health of an Indonesian company was often difficult to obtain from abroad.

The potential international market for Indonesian assets was also limited by the fact that many foreign fund managers, insurance companies and other institutional investors were restricted from purchasing assets that did not have a so-called "investment grade" credit rating from an internationally recognized credit rating agency.²¹⁵ No Indonesian bank or other corporation had an investment grade rating and, even had the Indonesian government agreed to guarantee certain assets to increase their marketability, Indonesia's own sovereign credit rating was well below investment grade.²¹⁶

One potential solution to broaden the international market for Indonesian assets was the use of a financing technique known as securitization.²¹⁷ Securitization involves creating negotiable securities backed by the cashflows from assets that are not themselves securities, such as loans, trade receivables and other types of payment rights.²¹⁸ In a typical securitization involving loans, a portfolio of loans is assigned by a bank to a special purpose vehicle.²¹⁹ The special purpose vehicle raises the funds necessary to purchase the loans by issuing notes to investors that are backed by the cashflows on such loans.²²⁰

Kong Real Estate, BLOOMBERG NEWS, June 26, 1998, available in LEXIS, News Library, Allbnn File.

²¹⁵ An investment grade rating is generally recognized to be a rating of "BBB" from Standard & Poor's Corporation, "bbb" from Moody's Investor Services, or an equivalent rating from another international credit rating agency such as Fitch/IBCA, Duff & Phelps or Thomson. See *HealthCare REIT, Inc. Announces Investment Grade Rating by Standard & Poor's*, BUS. WIRE, Feb. 10, 1998, available in LEXIS, Busfin Library, Bwire File.

²¹⁶ As of October 1998, Indonesia's senior debt was rated "B3" by Moody's Investor Services and "CCC+" by Standard & Poor's Corporation. See *Asian Capital Markets, MITI-Backed Malaysia Sovereign Bond to Test Water for Aid Package Financing*, EUROWEEK, Dec. 4, 1998, available in 1998 WL 21700758.

²¹⁷ See, e.g., Jason Singer, *For Asia, Securitizations May Be Best Hope: Financing Business*, BLOOMBERG NEWS, May 27, 1998, available in LEXIS, News Library, Allbnn File; John Authers & Richard Walters, *Markets, Not Banks, Call the Shots*, FIN. TIMES, Oct. 12, 1998, at 3.

²¹⁸ See Singer, *supra* note 217.

²¹⁹ See *id.*

²²⁰ See *id.*

Since the notes issued by the special purpose company are backed by a portfolio of loans made to different borrowers, purchasers of the notes enjoy a greater diversity of risk than if they had purchased the rights to the cashflows on a single loan.²²¹ Assuming the portfolio of underlying loans is sufficiently large and properly structured, a default by a borrower on any one of the loans will not have a significant impact on the pay-out on the notes.²²² The diversification of risk achieved through securitization permits the special purpose vehicle to issue notes that receive a higher credit rating than the credit rating of any of the individual borrowers on the underlying loans.²²³

Although securitization potentially could be used by the Indonesian government to assist in the disposal of bank assets, a number of outstanding issues need to be resolved before such a financing technique could become an effective tool for the government. One such issue is that international credit rating agencies will only rate the asset-backed notes issued in a securitization transaction if the local legal system in the country in which the underlying assets are located is well-developed and provides a high degree of certainty with regard to certain matters.²²⁴ Most importantly, the rating agencies need to be ensured that the transfer of the assets from the bank to the special purpose vehicle will be recognized as a true sale under the local legal system so that such

²²¹ See *id.*

²²² See *Europe Develops Taste for Asset-Backed Bonds: Rates of Return*, BLOOMBERG NEWS, Dec. 12, 1996, available in LEXIS, News Library, Allbnn File.

²²³ In a typical securitization transaction, the special purpose vehicle issues multiple tranches of notes. See *Credit Lyonnais to Repackage One Third of FF124 Billion Loan*, BLOOMBERG NEWS, July 3, 1996, available in LEXIS, News Library, Allbnn File. Each tranche of notes will generally have a different credit rating and a different yield. The holders of the highest rated tranche of notes will be protected from any reduction in the pay-out of their notes caused by a default of a single borrower on an underlying loan by the existence of one or more subordinated tranches of notes. Holders of the subordinated tranches of notes absorb the effect of defaults on the underlying loans up to a certain set percentage, and, in consideration of their assuming that risk, receive a higher rate of interest on their notes. See *Goldman Sells \$1.3 Bln Cmbs, CSFB Closes \$4 Bln Loans*, BLOOMBERG NEWS, May 14, 1998, available in LEXIS, News Library, Allbnn File.

²²⁴ See *Bank of Ireland Mortgage Bond Won't Spark Surge of U.K. Issues*, BLOOMBERG NEWS, July 13, 1994, available in LEXIS, News Library, Allbnn File.

assets will be outside the reach of creditors of the bank.²²⁵ Legal certainty on such matters was generally considered to be lacking in Indonesia because of the unpredictability of the Indonesian court system.²²⁶

Another limitation on the Indonesian government's ability to use securitization techniques to sell bank assets to foreign investors was that a portfolio made up entirely of loans to Indonesian borrowers was unlikely to be viewed by credit rating agencies as offering sufficient risk diversification to be eligible for a high credit rating.²²⁷ Rating agencies were likely to determine, therefore, that the occurrence of certain events, such as a collapse of the Indonesian banking sector, could cause defaults on all, or almost all, of the underlying loans.²²⁸ A portfolio subject to such highly correlated default risk is generally not seen as being sufficiently diversified to permit the creation of highly rated notes in a securitization transaction.²²⁹

The asset liquidation process was also a politically contentious issue for the Indonesian government. Most of the owners of the private banks were members of Indonesia's small, but economically powerful, ethnic Chinese minority.²³⁰ The disproportionate degree of economic power held by the ethnic Chinese minority, who made up roughly 2% of the country's population, was fre-

²²⁵ If the transfer of the underlying loans is not deemed a true sale, but rather is re-characterized as simply a granting by the bank to the special purpose vehicle of a kind of security interest in the loans, then, if a bankruptcy of the bank occurs, creditors of the bank may be able to attach the cashflows on the loans to satisfy their claims against the bank. See Claire A. Hill, *Latin American Securitization: The Case of the Disappearing Political Risk*, 38 VA. J. INT'L L. 293 (1998). In such a case, the pay out on the notes issued by the special purpose vehicle may be reduced if the bank becomes insolvent. See *id.* The notes issued by the special purpose company, therefore, will not be entitled to a credit rating higher than the credit rating of the bank that originated the loans. See *id.*

²²⁶ See 'Money & Power' Often Still Prevail in Indonesia Courts, JAKARTA POST, Sept. 17, 1998, available in 1998 WL 13122879.

²²⁷ See Arshad A. Ahmed, Comment, *Introducing Asset Securitization to Indonesia: A Method in Madness*, 19 U. PA. J. INT'L ECON. L. 823 (1998).

²²⁸ See *In Brief*, THOMSON'S INT'L BANKING REG., June 1, 1998, available in 1998 WL 4779713.

²²⁹ See Hill, *supra* note 225.

²³⁰ See Michael Richardson, *Critics Take Aim at Jakarta's Bank-Bailout Plan*, INT'L HERALD TRIB., Feb. 5, 1999, available in LEXIS, Asiapc Library, Iht File.

quently criticized by ethnic Indonesians.²³¹ The government was faced by demands from certain populist political groups to use the large scale nationalization of bank assets as an opportunity to redistribute wealth from the ethnic Chinese business community to ethnic Indonesians.²³²

In addition to liquidating the weakest banks and managing the asset liquidation process, the IBRA worked to reduce the total number of small, poorly capitalized banks in the country by promoting bank mergers.²³³ The IBRA was assisted in this regard by a special intra-governmental unit created by Bank Indonesia to facilitate bank mergers and other types of consolidations by reducing the time and cost involved in obtaining government approvals.²³⁴ By October 1998, the most significant merger to have been announced was a combination involving five of the state-owned banks, Bank Ekspor-Import, Bank Bumi Daya, Bank Dagang Negara, Bapindo and the corporate business of Bank Rakyat Indonesia.²³⁵

The merger plan for the five banks called for the banks to continue operating under their own names, but under common control of a single senior management, until their operations could be fully merged over the next two years into a new institution to be known as Bank Mandiri.²³⁶ During that two year period, the non-performing assets of each of the five banks would be transferred to the AMU.²³⁷ The Indonesian government also in-

²³¹ See *id.*

²³² See Schwartz, *supra* note 202.

²³³ See *Reform Is Crucial*, ASIaweek, Jan. 8, 1999, at 65, available in LEXIS, Asiawc Library, Asiawc File.

²³⁴ The unit was composed of representatives from Bank Indonesia, the Department of Finance, the Department of Justice, the Department of Home Affairs and the IBRA. See Bank Indonesia, *Formation of Merger, Execution, Consolidation and Acquisitions of Public Bank Co-ordinating Team*, (last modified Apr. 30, 1998) <<http://www.bi.go.id/intl/press/bi31pr12.htm>>.

²³⁵ See *Bank Indonesia August 24 Press Release*, *supra* note 191. With its corporate business transferred to the new Bank Mandiri, Bank Rakyat Indonesia was to be reconstituted as solely a rural development bank. See also Murphy & Moss, *supra* note 200.

²³⁶ See Bank Indonesia, *Muljohardjoko Appointed President Director of PT Bank Mandiri*, BLOOMBERG NEWS, Oct. 2, 1998, available in LEXIS, News Library, Allbnn File.

²³⁷ See *Indonesia: Mar'ie Muhammad Appointed Chief Commissioner of Bank Mandiri*, ANTARA INDON. NAT'L NEWS AGENCY, Oct. 2, 1998, available in 1998 WL 6588406.

tended to inject fresh capital into Bank Mandiri so that the new bank could emerge as a financially strong institution capable of being a leading bank in the restructured Indonesian banking system.²³⁸

The IBRA's responsibility for restructuring the banking sector also included implementing, together with Bank Indonesia, a recapitalization program for the banks that met certain minimum financial soundness criteria.²³⁹ Under the recapitalization program, all banks with a capital adequacy ratio of between 4% and negative 25% were required to provide Bank Indonesia with a business plan detailing their proposals for raising additional capital, either from existing shareholders or new investors.²⁴⁰ Based on those business plans, as well as audits of the banks undertaken by Bank Indonesia, the government would determine whether it believed that a bank's recapitalization plan was feasible.²⁴¹ Banks whose business plans were deemed feasible would then be eligible for a temporary injection of government funds from the IBRA while they undertook the private capital raising efforts detailed in their business plans.²⁴²

The Indonesian government was also under pressure from the International Monetary Fund to improve its prudential supervision of the country's banks.²⁴³ In response to such pressure, the Indonesian government began to examine ways to raise the quality of its banking supervision to be closer in line with interna-

²³⁸ See *Bank Indonesia August 24 Press Release*, *supra* note 191; *Indonesia: Bank Repayments*, *supra* note 26; see also Jason Singer, *Indonesia Bets on 'Bullet-proof Superbanks to Rebuild Economy*, BLOOMBERG NEWS, July 17, 1998, available in LEXIS, News Library, Allbnn File. The Indonesian government's hopes for the new Bank Mandiri were expressed in its name, which means "self-reliant bank" in Bahasa Indonesia.

²³⁹ See *Program for Rehabilitation of Indonesian Banks*, JAKARTA POST, Jan. 28, 1998, available in LEXIS, Asiapc Library, Jkpost File.

²⁴⁰ See *Indonesia: Bank Repayments*, *supra* note 26. Banks with capital adequacy ratios below negative 25 were to be liquidated or merged with other institutions. See Alistair Hammond, *Indonesia Tells Banks to Recapitalize or Face Gov't Takeover*, BLOOMBERG NEWS, Sept. 29, 1998, available in LEXIS, News Library, Allbnn File. On the recapitalization program generally, see *Bank Indonesia and National Private Banks Association Discuss the Banking Re-Capitalization Program* (visited Jan. 20, 1999) <<http://www.bi.go.id/intl/press/pr31-24.htm>> [hereinafter *Banking Re-Capitalization Program*].

²⁴¹ See *Banking Re-Capitalization Program*, *supra* note 240.

²⁴² See *Bank Indonesia August 24 Press Release*, *supra* note 191.

²⁴³ See Christopher Tacchio, *IMF, World Bank Say They Expect Action from Indonesia*, ASSOCIATED PRESS, Apr. 6, 1998.

tional standards.²⁴⁴ In particular, the government focused on increasing the frequency and completeness of financial disclosure by banks in order to enable regulators, as well as the public, to make a more accurate assessment of a bank's financial condition and performance.²⁴⁵ In early 1998, for example, Bank Indonesia began requiring banks to submit monthly reports setting out their capital adequacy ratio and details of their current liquidity position.²⁴⁶

Undertaking such reforms, however, required the Indonesian government to strike a delicate balance. The government had become aware by events in November 1997 of the inherent danger in pursuing structural reform in an unstable environment.²⁴⁷ Its decision at that time, based on International Monetary Fund advice, to close sixteen banks had backfired, further weakening public confidence in the banking system and leading to increased depositor withdrawals at many private banks.²⁴⁸ The economic

²⁴⁴ One common international standard was set out in the Core Principles of Effective Banking Supervision published by the Bank of International Settlements. See Basle Committee on Banking Supervision, *Core Principles of Effective Banking Supervision*, Sept. 1997, available in BIS Homepage, *supra* note 126. But see J. Soedradjad Djiwandono, *The Need for International Standards and Harmonization of Prudential Arrangement: An Emerging Market Perspective*, available in Bank Indonesia Homepage, *supra* note 6 (discussing the incompatibility of certain Bank of International Settlements' standards with the level of development of banking institutions in emerging market countries).

²⁴⁵ See *Welcome to Bank Indonesia*, *supra* note 113.

²⁴⁶ See *id.* The dependence of many of the country's banks on liquidity support in the wake of the Asian financial crisis provided Bank Indonesia with additional leverage to enforce the heightened prudential standards. For example, in March 1998, Bank Indonesia issued a decree setting out penalties, in the form of increased interest rates charged for use of the SBPU and SBI discount facilities, for banks that were in violation of the minimum statutory reserve requirement or had negative balances with Bank Indonesia. See *Decree of the Board of Directors of Bank Indonesia on Discount Facilities, Sanctions for Violations of the Minimum Statutory Reserves in Rupiah and Sanctions for the Negative Account Balances at Bank Indonesia* (visited Jan. 20, 1999) <<http://www.bi.go.id/intl/circular/sk9830271.htm>>.

²⁴⁷ See Aleksius Jemadu & Duncan McCargo, *Learning Lessons from Thailand*, JAKARTA POST, Apr. 15, 1998, available in LEXIS, Asiapc Library, Jkpost File.

²⁴⁸ For a criticism of International Monetary Fund policy in Indonesia and other countries affected by the Asian financial crisis, see Lucy Conger, *Whither the IMF?*, BLOOMBERG MAG., Oct. 1998, at 35; Devesh Kapur, *The IMF: A Cure or a Curse*, FOREIGN POL'Y, July 1, 1998, at 114; David E. Sanger & Richard W. Stevenson, *Second-Guessing the Economic Doctor*, N.Y. TIMES, Feb. 1, 1998, §3, at 1; Jeffrey Sachs, *Power Unto Itself*, FIN. TIMES, Dec. 11, 1997, at 21. For a response in defense of the International Monetary Fund, see Stanley Fischer,

damage caused by that policy decision highlighted for the government the risks of pursuing rapid financial reform without first establishing stable financial institutions.²⁴⁹

Indonesian banks suffered such poor financial health that the government also risked precipitating a system-wide collapse if it suddenly imposed strict standards that only a few of the strongest banks could meet. The government, in fact, relaxed requirements in certain areas to lessen the pressure on otherwise viable banks that temporarily were unable to meet certain prudential standards.²⁵⁰ In June 1998, for example, Bank Indonesia decreased its capital adequacy ratio targets for banks in the years 1998, 1999, and 2000. The Bank implemented the decrease to reflect the decline in capital ratios experienced by most of the country's banks due to the steep fall in the value of the rupiah.²⁵¹ The revised target of 4% for 1998 was only half of the minimum capital adequacy ratio advised by the Bank of International Settlements and ranked among the lowest capital adequacy requirements set by any of the world's central banks.²⁵²

Reforming World Finance: Lessons from a Crisis, ECONOMIST, Oct. 3, 1998, at 23.

²⁴⁹ See Jemadu & McCargo, *supra* note 247.

²⁵⁰ See P. Parameswaran, *Indonesian Central Bank Chief Rosy About Rupiah Despite Rate Cuts*, AGENCE FRANCE-PRESSE, Oct. 14, 1998.

²⁵¹ A bank's capital adequacy ratio is calculated by dividing the amount of its capital by the amount of its risk-weighted assets. See *Indonesia Says*, *supra* note 113 (describing a capital adequacy ratio as "a measure of loans to cash"). The principle behind the capital adequacy ratio is that each asset held by a bank should be backed by a certain amount of capital, depending on the implied risk of such asset. See *Govt to Close More Banks Later This Month*, JAKARTA POST, Feb. 5, 1999, available in LEXIS, Asiapc Library, Jkpost File. The devaluation of the rupiah caused a sharp decline in the capital adequacy ratios of most Indonesian banks because certain assets of the banks were denominated in U.S. dollars and other foreign currencies while their capital was denominated in rupiah. As a result, in rupiah terms, the size of their existing assets increased purely because of the effect of the changes in the foreign exchange rate. Bank Indonesia set 10% as the target for the period between October 1997 and September 1999, and 12% as the target thereafter. See *Banking Policies in Indonesia* (visited Jan. 19, 1999) <<http://www.bi.go.id/intl/policies/bankingpolicy.htm>>. The bank lowered the targets in June 1998 to 4%, 8% and 10% for 1998, 1999 and 2000, respectively. See *Indonesia: Bank Repayments*, *supra* note 26; Alistair Hammond & Dan Murphy, *Indonesia Cancels Minimum Capital Plan for Banks*, BLOOMBERG NEWS, June 19, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Minimum Capital Plan*].

²⁵² See *Indonesia Says*, *supra* note 113. For a general discussion of the Bank of International Settlements' capital adequacy ratio policy see George Melloan,

Moreover, the Indonesian government assumed a high degree of direct control over the banking industry in the wake of the Asian financial crisis. The government, therefore, had less immediate need to strengthen prudential banking regulations since it was controlling most of the country's banks through more direct means.²⁵³ In mature economies with well-developed financial institutions, regulators may be able to maintain stability in the banking sector during times of economic distress purely by relying on heightened supervision of bank activities and increased enforcement of prudential banking standards.²⁵⁴ Indonesia, however, did not have such a mature economy.²⁵⁵ The severity of the problems in the Indonesian banking sector brought on by the Asian financial crisis and the overall weakness of the country's banks forced the government to look beyond regulatory solutions and intervene directly in the market to prevent a system-wide collapse.²⁵⁶

The Indonesian government took such far reaching direct measures to stabilize the banking industry that its actions amounted to a quasi-nationalization of the banking system.²⁵⁷ Although the IBRA only identified four banks as completely nationalized "Category B" banks by October 1998, the Indonesian government assumed a high degree of direct control over the other private banks as well.²⁵⁸ The bank debt guarantee and bank recapitalization programs, for example, put significant areas of bank management, including such basic functions as setting deposit rates and determining credit growth, under government administration.²⁵⁹

The Indonesian government intended its nationalization of much of the banking industry to be a temporary response to the banking crisis.²⁶⁰ Once the banking sector and the general economy became more stable, the government planned to re-privatize

Maybe a More Modest Global 'Architecture' Is Needed, ASIAN WALL ST. J., Oct. 20, 1998, at 12.

²⁵³ See *Indonesia Says*, *supra* note 113.

²⁵⁴ See *id.*

²⁵⁵ See *id.*

²⁵⁶ See *id.*

²⁵⁷ See *id.* ("Nationalizing most of the industry 'is a done deal").

²⁵⁸ See generally *Who Is IBRA?*, *supra* note 175.

²⁵⁹ See *id.*

²⁶⁰ See *id.*

a number of the banks that had been put under IBRA control.²⁶¹ The government also considered the eventual privatization of the state-owned banks, including the newly created Bank Mandiri.²⁶² Similarly, assuming that purchasers could be found, the government intended to sell to the private sector most of the assets that it acquired in connection with the liquidation of the failed banks.²⁶³

Although limited in scope and intended only as an interim solution, the nationalization of much of the banking sector nonetheless represented a significant change from the government's banking policies for most of the previous ten years.²⁶⁴ From the 1988 banking package to the onset of the Asian financial crisis in 1997, the Indonesian government's deregulation of the country's banking industry had been based largely on orthodox free-market economic principles.²⁶⁵ The government opened the industry to increased private competition, reduced the traditional advantages enjoyed by state-owned institutions, and generally moved to permit market forces, rather than government decrees, to determine basic banking policies, such as the setting of deposit rates and the allocation of loans.²⁶⁶

Viewed from the perspective of free-market economic theory, the Indonesian government's banking liberalization program was the correct policy course.²⁶⁷ The response of the international financial community to the reforms reaffirmed the correctness of the government's policies.²⁶⁸ Multi-national organizations, such as the World Bank, the International Monetary Fund and the Asian Development Bank, as well as many leading private sector financial institutions, including foreign commercial and invest-

²⁶¹ See *id.*

²⁶² The Indonesian government appointed Germany's largest commercial bank, Deutsche Bank, to advise it on the management of Bank Mandiri and to formulate a plan for its eventual privatization. See Lau & McAllum, *supra* note 167; *Indonesia: Bank Repayments*, *supra* note 26.

²⁶³ See generally *Who Is IBRA?*, *supra* note 175.

²⁶⁴ See generally Jay Solomon, *Indonesia Shuts 38 Banks in Sweeping Action; IMF Says It's Ready to Disburse Rest of Bailout*, WALL ST. J., Mar. 15, 199, at A13.

²⁶⁵ See *id.*

²⁶⁶ See *id.*

²⁶⁷ See Indrawati & Wardono, *supra* note 26 (discussing the "virtual soundness" of the government's banking reforms).

²⁶⁸ See Solomon, *supra* note 264, at A13.

ment banks, fund management companies and other institutional investors, rewarded Indonesia for its liberalization efforts by making a great deal of financing available to the Indonesian banking sector.²⁶⁹

The pace of the liberalization program, however, far exceeded that of the development of banking institutions in Indonesia.²⁷⁰ Few of the country's banks possessed sufficiently developed risk management or other control systems that would permit the banks to operate safely in a deregulated environment.²⁷¹ This lack of effective internal controls, combined with the government's failure to adequately supervise the banks' operations and ensure compliance with prudential standards, resulted in banks engaging in the types of high risk practices described in the previous section of this Article.²⁷² The unsound lending practices in turn resulted in banks accumulating high levels of non-performing loans that left the banks very vulnerable to the economic shocks of the Asian financial crisis.²⁷³

The lesson that the Indonesian government appeared to learn from the banking crisis is that liberalization should follow, not precede, the development of financially strong institutions and a sound framework of prudential supervision. That lesson influenced the government's decision in 1998 to nationalize much of the banking system until market conditions stabilized.²⁷⁴

Nationalization of banks reversed the Indonesian government's decade-long policy of deregulating the banking system and reducing direct state involvement in the bank market. Although the international financial community generally supported the earlier liberalization policy, including multi-national institutions such as the World Bank and the International Monetary Fund, the policy proved itself incapable of producing a financially sound banking system resilient to external shocks.²⁷⁵ In light of this history, the Indonesian government's decision to suspend its faith in free-market economic theory and assume direct government con-

²⁶⁹ See *id.*

²⁷⁰ See generally *Who Is IBRA?*, *supra* note 175.

²⁷¹ See *id.*

²⁷² See *supra* Section 3.

²⁷³ See generally *Who Is IBRA?*, *supra* note 175.

²⁷⁴ See Solomon, *supra* note 264.

²⁷⁵ See generally *Who Is IBRA?*, *supra* note 175.

trol over much of the banking industry can be seen as a natural response to the Asian financial crisis.

5. CONCLUSION

The Asian financial crisis devastated the Indonesian banking sector. After a decade in which both the number of banks and the total amount of outstanding bank credit had expanded annually, the Asian financial crisis significantly damaged the financial health of all of the country's banks and caused an overall contraction of the banking industry.²⁷⁶ By October 1998, a governmental decree liquidated twenty-six banks, more than half of the loans in the banking system did not perform,²⁷⁷ and either the IBRA or Bank Indonesia directly controlled roughly seventy percent of the total assets held by the country's banks.²⁷⁸

The banking sector in many other Asian countries also suffered from liquidity shortages and escalating levels of non-performing loans during the Asian financial crisis.²⁷⁹ Many of the weaknesses of the Indonesian banking system, such as poor regulatory supervision, a lack of bank transparency,²⁸⁰ and excessive short-term, unhedged foreign currency borrowing, were common throughout the region.²⁸¹ In particular, banks in South Korea, Malaysia and Thailand experienced problems similar to those in Indonesia and required significant levels of governmental support to survive the crisis.²⁸²

²⁷⁶ See generally *id.*

²⁷⁷ In October 1998, the Asian Wall Street Journal estimated that 75% of the loans in the Indonesian banking sector were non-performing. See Darren McDermott, *Hints of a Recovery in Asia Stir Debate over Readiness: How Much Suffering Will Heal a Sick Economy?*, ASIAN WALL ST. J., Oct. 22, 1998, at 1.

²⁷⁸ See *Indonesia Says*, *supra* note 113.

²⁷⁹ See McDermott, *supra* note 277.

²⁸⁰ The Bank of International Settlements defines "bank transparency" as "public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practices." Basle Committee on Banking Supervision, *The Basle Committee Issues Guidance on Bank Transparency* (last modified Sept. 22, 1998) <<http://www.bis.org/press/index.htm>>.

²⁸¹ See Shirazi, *supra* note 16.

²⁸² Two other Southeast Asian countries whose currencies were affected by the Asian financial crisis, the Philippines and Singapore, had relatively strong banking systems and did not experience problems to the degree seen in Indonesia, Thailand, Malaysia and South Korea. For a discussion of the effect of the

In South Korea, for example, because of the extremely tight liquidity conditions prevailing in late 1997 and early 1998, many of the country's banks encountered difficulty refinancing their maturing obligations.²⁸³ To avoid widespread bank defaults, in March 1998, the government offered to guarantee the short term debts incurred by South Korean banks.²⁸⁴ The guarantee was provided in the form of an exchange offer under which creditors were permitted to exchange short-term bank debt for newly issued one, two and three-year government guaranteed loans.²⁸⁵ The Indonesian government later used this exchange offer in June and July 1998 as the model to carry out a similar bank debt exchange program.²⁸⁶ The South Korean government also set-up a company called the Korea Asset Management Corporation to acquire non-performing loans from banks.²⁸⁷

Likewise, serious bank liquidity problems and a large number of bad loans in Malaysia and Thailand caused the governments of those two countries to undertake bank restructuring programs.²⁸⁸ As in Indonesia, the Malaysian and Thai governments aimed to foster consolidation in their banking markets through mergers and liquidations of weak banks, to strengthen the capital base of the surviving institutions and to create a mechanism for the disposal of non-performing loans.²⁸⁹ To manage the bank restructur-

crisis on the Philippines' banking sector, see, for example, *Real Crisis*, *supra* note 36, at 46-47. For a discussion of the effect of the crisis on the Singapore banking sector, see, for example, Richard Borsuk & Roger Malone, *Singapore's Banks Called Sound, Despite Asian Crisis*, *ASIAN WALL ST. J.*, Aug. 25, 1998, at 3.

²⁸³ See Bank of Korea Homepage (last visited Feb. 3, 1999) <<http://www.bok.or.kr>>.

²⁸⁴ See *id.*

²⁸⁵ See Bill Austin & Yoolim Lee, *S. Korea, Creditors Complete \$21.37 Billion Debt Swap*, *BLOOMBERG NEWS*, Mar. 13, 1998, available in LEXIS, News Library, Allbnn File. The exchange offer covered approximately US\$3.7 billion of South Korean bank debt for the first year. See *id.*

²⁸⁶ See text *supra* note 167.

²⁸⁷ See *Bank of Korea Homepage*, *supra* note 283.

²⁸⁸ See Philip Delhaise, *Healing Thailand's Banks*, *ASIAN WALL ST. J.*, Aug. 21, 1998, at 10 (discussing the Thai recapitalization program); Standard & Poor's, *S&P Views First Round of Malaysian Bank Recapitalization Positive*, *BLOOMBERG NEWS*, Oct. 8, 1998, available in LEXIS, News Library, Allbnn File [hereinafter *Malaysian Bank Recapitalization*] (discussing the Malaysian recapitalization program).

²⁸⁹ See Delhaise, *supra* note 288; *Malaysian Bank Recapitalization*, *supra* note 288.

ing process, the governments of both countries created new entities similar to Indonesia's IBRA and AMU.²⁹⁰

The Malaysian government established two separate entities in the form of special purpose limited liability companies. One company, known as Danamodal, received a mandate similar to the IBRA to manage the overall restructuring process and administer the government's recapitalization of the banking sector.²⁹¹ The other company, known as Danaharta, undertook an equivalent role to the AMU to acquire non-performing loans from banks.²⁹² By October 1998, Danamodal had selected ten Malaysian banks and finance companies to be recapitalized with, in the aggregate, the Malaysian ringgit equivalent of approximately US\$850 million,²⁹³ and Danaharta had purchased a portfolio of nonperforming loans from Sime Bank and a delinquent property-related loan from a Malaysian merchant bank.²⁹⁴

In October 1997, the government of Thailand established an agency to manage the bank restructuring process, known as the Financial Sector Restructuring Authority,²⁹⁵ as well as a state-owned asset management company to acquire loans from banks

²⁹⁰ See Delhaise, *supra* note 289.

²⁹¹ Danamodal's full legal name is Danamodal Nasional Berhad. See *Details on Establishment of Danamodal Nasional Berhad* (last modified Aug. 4, 1998) <<http://www.bnm.gov.my>> (discussing the creation of Danamodal).

²⁹² Danaharta's full legal name is Pengurusan Danaharta Nasional Berhad. See *Danaharta, Asset Management Company Details Announced* (visited Jan. 28, 1999) <<http://www.danharta.com.my/public/asset.html>> (discussing the creation of Danaharta); see also *Danaharta's Acquisition Approach* (visited Jan. 28, 1999) <<http://www.danharta.com.my/public/approach.html>> (reporting that Danaharta's strategy involved acquiring non-performing loans with a minimum principal amount of RM5 million in consideration for government guaranteed bonds that it would issue).

²⁹³ See Managing Director Azman Yahya, *Acquisition Agreement Between Danaharta and Eleven Financial Institutions* (last modified Nov. 11, 1998) <<http://www.danharta.com.my/public/acquisition.html>>.

²⁹⁴ See Chairman Yabghm Raja Tun Mohar Raja Badiozaman, *Chairman's Statement on Agreement Between Sime Bank Berhad, Pengurusan Danaharta Nasional Berhad and Bank Negara Malaysia* (visited Jan. 21, 1999) <<http://www.danharta.com.my/public/sime.html>>; T.H. Chan, *Danaharta to Manage 6 Bln Ringgit in Sime's Bad Loans*, BLOOMBERG NEWS, Oct. 16, 1998, available in LEXIS, News Library, Allbnn File; see also Peter Montagnon & Sheila McNulty, *Malaysian Banks Ordered to Lend and Lend*, FIN. TIMES, Oct. 7, 1998, at 4.

²⁹⁵ See King Bhumibol Adulyadej, *Emergency Decree on Financial Sector Restructuring B.E. 2540* (last visited Jan. 21, 1999) <<http://www.bot.or.th/govnr/public/news/ae.htm>>.

being liquidated.²⁹⁶ In general, the Thai government planned to restructure the banking sector by injecting cash directly into the country's strongest banks by purchasing preference shares and subordinated debt from them in exchange for government guaranteed bonds. Other banks that were not sufficiently sound enough to merit recapitalization with government funds were to be merged or liquidated, with their assets transferred either to the asset management company or to the state-owned Krung Thai Bank.²⁹⁷

As the experience of South Korea, Malaysia and Thailand illustrate, the problems experienced by the Indonesian banking sector during the Asian financial crisis, as well as the types of responsive remedial action by the government, were not unique. A number of factors, however, differentiate the banking crisis in Indonesia from those in the other affected Asian countries. One such factor was the sheer number of banks involved. At the onset of the Asian financial crisis, Indonesia had over 230 banks.²⁹⁸ In contrast, there were only fifteen commercial banks in Thailand

²⁹⁶ See King Bhumibol Adulyadej, *Emergency Decree on the Asset Management Corporation* B.E. 2540 (last visited Jan. 21, 1999) <<http://www.bot.or.th/govnr/public/news/be.htm>>. In August 1998, the government also established rules to facilitate the creation of private asset management companies to purchase bank assets. See *Joint Statement by the Ministry of Finance and the Bank of Thailand: Financial Sector Restructuring for Economic Recovery*, BLOOMBERG NEWS, Aug. 14, 1998, available in LEXIS, News Library, Allbnn File; see also *Bank of Thailand Homepage Regulations for Debt Restructuring and Collateral Appraisal* (last visited Feb. 3, 1999) <<http://www.bot.or.th/fsupv/public/cdraco/frame.htm>>.

²⁹⁷ Krung Thai Bank was 80% owned by the Thai government. See Lee J. Miller, *Krung Thai Bank to Overhaul Loan Approval System, Chairman Says*, BLOOMBERG NEWS, Sept. 2, 1998, available in LEXIS, News Library, Allbnn File. As of October 1998, the government had used Krung Thai Bank to absorb the assets of two liquidated banks, First Bangkok City Bank and Bangkok Bank of Commerce. See *id.* Krung Thai Bank, however, was suffering from a heavy burden of non-performing assets of its own. See *id.* As of September 1998, for example, it was reported that 32% of the Krung Thai Banks loans were delinquent by at least three months. See *id.* Several analysts expressed concern that Krung Thai Bank was not sufficiently sound to take on additional non-performing assets from insolvent banks. See, e.g., Brian Caplen, *Which Banks Will Weather the Storm?*, EUROMONEY, Oct. 1998, at 44, 47 (discussing emerging market bank rating systems as well as Caribbean and Mediterranean banks that have avoided fallout from global markets); see also Bank of Thailand, *Restructuring of Krung Thai Bank* (last visited Jan. 21, 1999) <<http://www.bot.or.th/fsupv/public/hotline/ea004.doc>>.

²⁹⁸ See *Foreigners Key to Regional Bank Reconstruction*, BUS. DAY (Thailand), Jan. 26, 1998, at 4.

and less than thirty in either Malaysia or South Korea.²⁹⁹ Because of the large number of banks, the Indonesian government faced a particularly complicated task in restructuring the banking industry. Indonesian bank regulators were faced, for example, with a substantially higher number of banks to audit and, ultimately, many more financially unsound banks to liquidate than were their counterparts in Thailand, Malaysia or South Korea.

Another factor that distinguished the Indonesian banking sector from those of the other three countries was that the great majority of Indonesia's banks were privately held institutions. As of the beginning of 1998, less than thirty of the country's banks were listed on a stock exchange, meaning that only a small percentage of the banking sector was subjected to the disclosure requirements and market discipline that comes with having publicly traded shares.³⁰⁰ Although poor financial disclosure by banks presented problems throughout Asia, Indonesia's unlisted private banks particularly lacked bank transparency.³⁰¹ Many Indonesian private banks, for example, did not release any information regarding the performance of their loan portfolios.³⁰²

Indonesian banks also contained much smaller average total assets than banks in Thailand, Malaysia and South Korea.³⁰³ Although the size of the twenty largest banks in Indonesia was on par with that of banks in the other three countries, the average Indonesian bank held only US\$500 million in assets.³⁰⁴ The proliferation of small banks was due principally to the desire of many Indonesian business groups to maintain an in-house bank.³⁰⁵ Because such banks existed mainly to finance the business operations of their owners, the funding needs of the affiliated business

²⁹⁹ For statistics on Thai, Malaysian and South Korean banks, see *Bank Negara Malaysia Homepage* (last visited Feb. 3, 1999) <<http://www.bnm.gov.my>>; *Bank of Thailand Homepage* (last visited Feb. 3, 1999) <<http://www.bot.or.th>>; *Bank of Korea Homepage*, *supra* note 283.

³⁰⁰ See *Pushed to the Brink*, *supra* note 145.

³⁰¹ See Standard & Poor's Creditwire Report on Indonesia, *supra* note 33.

³⁰² See *id.*

³⁰³ See *Bank Atlas*, *supra* note 134.

³⁰⁴ See *id.* In comparison, based on 1997 figures, 12 of the 15 commercial banks in Thailand had total assets in excess of US\$4 billion; the smallest commercial bank in Korea, Kangwon Bank, had assets in excess of US\$2 billion; and none of the top 50% of commercial banks in Malaysia had total assets below US\$2 billion. See *id.*

³⁰⁵ See *Top-Level Shakeout*, *supra* note 4, at 55.

group limited the growth of the bank's assets.³⁰⁶ As a result, even viewed in the relatively modest context of Asian banking, many of Indonesia's banks resembled small curb-side lenders rather than full-fledged commercial banks.

Despite the extent of the problems afflicting Indonesian banks, by October 1998, conditions in the Indonesian banking sector had begun to show signs of stabilizing. Many of the weaker banks had been liquidated and several others were under government administration. The Indonesian public also began regaining confidence in the banking system, evidenced by an aggregate five percent increase in deposits into the private banks in July and August 1998.³⁰⁷ The increase in deposits, combined with the generally lower domestic interest rates³⁰⁸ and the strengthening of the rupiah against the U.S. dollar,³⁰⁹ reduced the liquidity pressure on the Indonesian banking sector.³¹⁰

Although the Indonesian government succeeded in averting a system-wide banking collapse, none of the actions the government had taken by October 1998 were likely to be sufficient to cure the fundamental structural problems in the banking sector.

³⁰⁶ In order to maintain their capital adequacy ratios, banks must increase the amount of capital that they hold each time the size of their assets rises. Therefore, if the owners of a bank see the primary value of the bank as a funding source for their own business activities, they will permit the bank's assets to grow only to the extent necessary to finance those activities. Accumulating additional assets that are unrelated to the owners' business is generally considered undesirable because the owners would need to inject additional capital to support those assets. A privately held bank that has been established as a captive lender for its controlling shareholders will unlikely, therefore, grow much beyond the size required to finance the owners' businesses. See generally *Indonesia Detains Two Bankers*, *supra* note 19; *Modern Group Pledges*, *supra* note 109.

³⁰⁷ See Alistair Hammond, *Deposits at Private Indonesian Banks Up 5.1% in July, August*, BLOOMBERG NEWS, Oct. 12, 1998, available in LEXIS, News Library, Allbnn File.

³⁰⁸ From early September to mid-October 1998, the interest rate on one-month SBIs declined by approximately 10%. See, e.g., *Indonesia to Liquidate 10 Banks Frozen by Restructuring Agency*, ASIAN WALL ST. J., Oct. 21, 1998, at 3 (discussing Indonesia's plans to liquidate ten banks previously frozen by the Indonesian Bank Restructuring Agency).

³⁰⁹ After reaching a high of USD 1 = IDR 16,150 on June 17, 1998, the value of the rupiah steadily strengthened against the U.S. dollar from late July to October 1998. The spot exchange rate was USD 1 = IDR 13,200 on August 17, 1998 and USD 1 = IDR 7,200 on October 21, 1998. See Bloomberg News Service, *Close/Value* (search for Indonesian Rupiah Spot from June 1, 1998 to Oct. 30, 1998).

³¹⁰ See Bank of Indonesia, *Banks Liquidity Getting Better* (last visited Jan. 26, 1999) <<http://www.bi.go.id>>.

Liquidating insolvent banks, for example, removes the weakest banks from the industry, but does nothing to strengthen the surviving institutions. Similarly, a merger of several small, financially weak banks is more likely to create one large, financially weak bank than a strong institution.³¹¹

Even a recapitalization of the banking sector is unlikely to generate long-term benefits unless the conditions that led originally to the need for such recapitalization have been removed. In the case of Indonesia, those conditions were poor regulatory oversight, a weak regulatory framework and inherent conflicts of interest of many bank managers. As long as such conditions continued to exist in the Indonesian banking sector, injecting additional capital into the country's banks was apt to lead to a repetition of the problems that the government was seeking to solve.

The most pressing issue, therefore, facing the Indonesian government as of October 1998 was to create a new framework for the banking sector so that the government could safely lift its temporary nationalization policy. Without such a framework, the danger existed that, once re-privatized, the banking sector would revert to the poor quality of internal management and external supervision that had been present when the government rescued the industry during the Asian financial crisis. The initial actions taken by the government to prevent a banking sector collapse, such as guaranteeing bank debts, liquidating and nationalizing weak banks, promoting bank mergers and formulating recapitalization plans, were all, in a sense, simply preparatory work for the fundamental structural reform of the banking sector that still needed to occur before it could be returned fully to private control.³¹²

The Indonesian government took an important first step toward building a new framework for the banking sector with the Parliament's passage on October 16, 1998 of an amendment to the

³¹¹ Similarly, the acquisition of a weak bank by a relatively strong bank can weaken the acquirer. In 1994, a consortium of three banks, including Bank Danamon and Bank Central Asia, took control over the insolvent Continental Bank. Four years later, both Bank Danamon and Bank Central Asia were taken over by the IBRA. See *Bank Central Asia, Danamon, 11 Other Banks Surrender Assets to Govt*, AFX, Sept. 18, 1998, available in 1998 WL 15898194.

³¹² See generally *Bank Indonesia January 27 Press Release*, *supra* note 170 (discussing the different steps in the comprehensive rehabilitation of the Indonesian banking system).

Banking Law.³¹³ As part of its negotiations with the International Monetary Fund for financial assistance, the government committed to revising the Banking Law by the end of 1998.³¹⁴ These amendments laid the groundwork for many important regulatory changes to the banking system.

For example, the amendment rescinded the foreign ownership limitation in the prior Banking Law which restricted foreign parties from purchasing, in the aggregate, more than forty-nine percent of the shares of a domestically incorporated bank.³¹⁵ Because of the reputation of Indonesian banks for poor management, few foreign banks had been interested in purchasing a minority stake in an Indonesian bank. As a result, the restriction against foreign majority control over a local bank had severely limited the interest of foreign banks in participating in the bank recapitalization effort in Indonesia.³¹⁶ The amendment also established the framework for an insurance scheme of all commercial bank deposits and revised a number of prudential regulations.³¹⁷ For example, in the area of prudential regulations the amendment limited the definition of bank secrecy in the interest of increasing bank transparency.³¹⁸

The Asian financial crisis reversed a thirty year trend of economic growth in Indonesia and sent tens of millions of Indonesians back into poverty.³¹⁹ The extent of the decline of the country's economy was profound. For example, the country's

³¹³ See *Indonesia Banks to Be Bolstered by Revised Law*, ASIAN WALL ST. J., Oct. 19, 1998, at 3 [hereinafter *Revised Law*].

³¹⁴ See generally *Bank of Sinar Mas Group*, *supra* note 108, at 13.

³¹⁵ See *id.*

³¹⁶ For a discussion of the potential interest of foreign banks in purchasing stakes of Indonesian banks, see Singer, *supra* note 238; see also, Richard Borsuk, *Indonesia's Bank Bali Seeks Major Foreign Shareholder*, ASIAN WALL ST. J., Sept. 17, 1998, at 3.

³¹⁷ See *Revised Law*, *supra* note 313.

³¹⁸ See *id.*; see also *Indonesia: Bank Repayments*, *supra* note 26. Bank secrecy provisions had limited the public's ability to obtain all information concerning the assets and liabilities of the private banks. The amendment limited the types of information covered by the bank secrecy rules to information regarding depositors and their deposits. See *id.*

³¹⁹ See, e.g., Jeffrey Wagstaff, *Rethinking Asia: Indonesia's Poverty: How Bad Is It?*, ASIAN WALL ST. J., Oct. 26, 1998, at S13 (discussing difficulties in gauging Indonesian poverty levels); Jeremy Pelofsky & Emily Schwartz, *Indonesia's Social Problems Demand Attention*, *Wolfensohn Says*, BLOOMBERG NEWS, Mar. 20, 1998, available in LEXIS, News Library, Allbnn File (discussing the need to address unemployment, hunger, and a rising crime rate).

nominal gross domestic product per capita was estimated to have fallen from US\$1,155 in 1996 to only US\$380 in 1998.³²⁰ By re-establishing a banking system capable of funding economic growth in the country, Indonesia began the recovery of its economy. As of October 1998, the Indonesian government's temporary nationalization of much of the banking sector appeared to have succeeded in preventing a total banking system collapse. Significant work remained, however, in order for the government to establish the foundation for a sound domestic banking system going forward.

³²⁰ See *Rethinking Asia: The Search for Solutions*, ASIAN WALL ST. J., Oct. 26, 1998, at S3 (discussing the possibility of debt relief as a solution to Asia's economic contraction).

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